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UNEMPLOYMENT COMPENSATION EXTENDED BENEFITS PROGRAM AND INCLUSION OF TAX-EXEMPT INCOME IN THE TAXATION OF SOCIAL SECURITY BENEFITS

HEARING

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY AND
INCOME MAINTENANCE PROGRAMS

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

S. 1113

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UNEMPLOYMENT COMPENSATION EXTENDED BENEFITS PROGRAM AND INCLUSION OF TAX-EXEMPT INCOME IN THE TAXATION OF SOCIAL SECURITY BENEFITS

MONDAY, AUGUST 1, 1983

U.S. SENATE,
SUBCOMMITTEE ON SOCIAL SECURITY
AND INCOME MAINTENANCE PROGRAMS,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 2:45 p.m. in room SD-215, Dirksen Senate Office Building, Hon. William L. Armstrong (chairman) presiding.

Present: Senators Armstrong, Danforth, Heinz, Chafee, Matsunaga and Long.

[The press release announcing the hearing, the description of S. 1113 by the Joint Committee on Taxation and the prepared statements of Senators Dole, Durenberger, and Long follow:]

[Press Release]

FINANCE SUBCOMMITTEE ON SOCIAL SECURITY AND INCOME MAINTENANCE PROGRAMS SETS OVERSIGHT HEARING ON EXTENDED UNEMPLOYMENT BENEFITS PROGRAM AND INCLUSION OF TAX-EXEMPT INCOME IN THE TAXATION OF SOCIAL SECURITY BENEFITS

Senator William L. Armstrong (R., Colorado), Chairman of the Subcommittee on Social Security and Income Maintenance Programs, announced today that the Subcommittee will hold a hearing on August 1, 1983 on the Unemployment Compensation Extended Benefits (EB) Program.

The Subcommittee will also hear testimony on S. 1113 (introduced by Senator D'Amato (R., New York)) which would repeal provisions of the 1983 Social Security Amendments that require the inclusion of tax exempt income in determining whether social security benefits would be taxed.

The hearing will begin immediately following the hearing of the Subcommittee on Taxation and Debt Management which was announced in press relese 83-160. That hearing is scheduled to begin at 2:00 p.m. on August 1, 1983, in SD-215 (formerly room 2221) of the Dirksen Senate Office Building.

In announcing the hearing, Senator Armstrong noted that the Omnibus Budget Reconciliation Act of 1981 made several significant changes in the Federal-State program of extended benefits for unemployed workers. "The Reconciliation Act made important reforms in the Extended Benefits Program," Senator Armstrong said, "it will be worthwhile for the Subcommittee to examine the effect of these reforms over the past two years."

Of particular interest to the Subcommittee will be testimony dealing with the method of calculating the insured unemployment rate which is used to trigger on the EB program as well as the trigger levels for the program. "In 1981 the change in the calculation of the insured unemployment rate and the increase in State triggers were supported by the Senate with no vocal opposition," Senator Armstrong said, "I am aware that these reforms may have changed some States to trigger off extended benefits while unemployment problems may persist. We will want to evaluate these changes keeping in mind the impact of the temporary supplemental benefits program enacted last summer to aid the long-term unemployed."

STATEMENT OF SENATOR DOLE—SUBCOMMITTEE ON SOCIAL SECURITY AND INCOME MAINTENANCE PROGRAMS, OVERSIGHT HEARINGS ON THE EXTENDED BENEFITS PROGRAM

Mr. Chairman, I appreciate your scheduling this oversight hearing on the extended benefits (EB) program, an important part of the Federal-State unemployment compensation system. Congress made significant changes in the extended benefits program as part of the Omnibus Budget Reconciliation Act of 1981. Although these changes have been in place for less than two years, it is important to examine their impact on the program and its beneficiaries.

The 1981 changes which we will look at this afternoon include the elimination of the national trigger for the extended benefits program; the increase in the State trigger levels from 4 percent to 5 percent and from 5 percent to 6 percent for the optional trigger; and the exclusion of EB claimants from the calculation of the insured unemployment rate (IUR). The Congressional Budget Office has estimated that these changes will save a total of $4 billion in fiscal year 1983.

It is apparent that these reforms have caused some States to trigger off extended benefits while unemployment problems persist. This problem has been eased somewhat by the enactment, in the Tax Equity and Fiscal Responsibility Act of 1982, of the Federal supplemental compensation (FSC) program which provides additional unemployment benefits financed entirely by the Federal Treasury. That program was extended in the Surface Transportation Act of 1982 and in the Social Security Amendments of 1983.

The program is now scheduled to expire on September 30, 1983. However, I will hold hearings in the full committee in early September to consider the need for a further extension. By the end of September, this program will have provided benefits to over 5 million unemployed workers at a cost of nearly $6 billion. Surely this demonstrates a real commitment on the part of Congress, the administration, and the taxpayer to providing relief during this period of seriously high unemployment.

A number of my colleagues believe, however, that the 1981 reconciliation changes were unfair and ill-advised. Some advocate the establishment of permanent supplemental program and changes which would increase the availability of extended benefits. Hopefully, today's hearing will allow us to examine both the affects of the 1981 reforms and the possible impact of changes in those reforms. We know that businesses are already reeling under massive payroll taxes and we know that State unemployment trust funds are going bankrupt in ever-increasing numbers. Any changes which allow the EB program to trigger on more readily or which unnecessarily prolong the EB program will only exacerbate these problems.

Finally, I think it is important that this subcommittee and the Congress in general begin to consider the basic questions underlying the unemployment compensation system: How much can and how much should an unemployment system do in our society? When does unemployment cease to be a matter of unemployment insurance and when does it become a social welfare issue? As we are faced with increasing long-term unemployment and the problems of the so-called dislocated worker, we cannot ignore these basic questions.

I look forward to this afternoon's testimony.

STATEMENT BY SENATOR DAVE DURENBERGER ON UNEMPLOYMENT COMPENSATION EXTENDED BENEFITS

This afternoon we'll hear about efforts made to protect the millions of Americans who are out of work through no fault of their own. We probably would have heard of more severe hardships if we hadn't provided essential temporary relief through the supplemental compensation program, which was extended in the Social Security bill this spring. However this program is soon to expire—all the more reason we need to examine our extended benefit program. I commend you, Mr. Chairman, for holding this hearing on the extended benefit program and the effects of the changes in the trigger made in 1981.

In the Omnibus Budget Reconciliation Act of 1981, we eliminated the national trigger for the extended benefit program. In 1981, we were told that the "national trigger" could result in adding, as much as, up to three months of benefits in a state that was not experiencing growth in their unemployment levels. At the time, we were being responsibe and sensitive to the needs of the individual states, rather than the nation as a whole.

In that same rationale, I firmly believe we need to be additionally responsive to the local needs within a state. Our current law treats a state as a single entity when determining eligibility for extended benefits. This ignores the fact that areas within a state—such as Minnesota's Iron Range—may suffer extremely high and prolonged unemployment, despite the fact that the state's overall unemployment rate may be below the "trigger rate" for extended benefits.

I've introduced legislation that is more responsive to an individual area within a state. Through the use of an area trigger, the legislation permits states to make high unemployment areas eligible for extended benefits even though the state as a whole does not qualify. To be eligible, an area would have to have an insured unemployment rate (IUR) of 6 percent or higher.

The Secretary of Labor would designate the areas, which generally would have a minimum population of 50,000. A person living or previously working in an area with a 6 percent IUR would be eligible to receive these extended benefits after his or her regular and supplemental benefits are exhausted. As with the present extended benefit program, the cost would be shared equally by the Federal government and the state.

The legislation has been criticized for requiring the collection of unemployment data not presently collected, which would increase the burden of administering the program. However, under the job Training Partnership Act, we established service delivery areas within a state—Minnesota has 12 such areas. Under the law unemployment statistics are collected for each area. Certainly this is one option to look at when we hold hearings on my legislation, as we work to establish a balance between area needs and administration concerns.

Minnesota's unemployment situation illustrates the need for an area trigger. The state's June total unemployment level, the most recent data available, was 8.1 percent. The IUR was under 5 percent—below the trigger level for extended benefits.

Yet, the unemployment levels in the state vary tremendously—from 33.7 percent in Lake County to 3.6 percent in Rock County. Five counties have unemployment rates that are twice the state average.

In fact, in April, when I introduced the "area trigger" bill, Lake County's unemployment rate was 25.9 percent. In Lake County the unemployment rate is increasing, while throughout the nation statistics indicate that unemployment rates are decreasing. Further, since April, Minnesota's IUR has decreased to the point that the state no longer qualifies for extended benefits. It seems unfair that there are areas out there, such as the Iron Range, that are undergoing severe economic changes, while other areas are participating in the burgeoning economic recovery. And yet, as a result of our current law, these hardship areas are not afforded extended benefits.

Chronic long-term unemployment is like the stone dropped into a calm pond. The ramifications of long-term unemployment expand like ripples in the pond, and the cumulative affects are devastating—increased infant mortality, families going hungry, vital medical care foregone, increased child abuse, and domestic violence. These are only some of the ramifications of long-term unemployment.

The unemployed need relief, but our system of unemployment compensation will never address the problem of high unemployment pockets without fundamental reform. The people of the Iron Range need it, Minnesota needs it, and others in high unemployment areas need it. Today, as we examine the extended benefit program, I hope we'll seriously consider reforming the program to be more sensitive to local needs.

STATEMENT OF SENATOR RUSSELL B. LONG

Mr. Chairman, I am pleased to be a cosponsor of S. 1113. Unless this legislation is enacted, the Federal Government will, starting in 1984, begin to tax social security benefits in a way that will effectively impose the Federal income tax on State and local bond interest.

Mr. Chairman, it is my own view that the inclusion of State and local bond interest in the income base for calculating the tax on social security benefits is unconstitutional. Even if this law were not unconstitutional, it would still be unwise and unnecessary.

I am concerned that this law will create a great deal of unertainty in the municipal bond market, and that this uncertainty will lead to higher interest costs for our States and localities. For the first time, taxpayers will be required to disclose on their tax returns the amount of their exempt interest income. Once people see the lines on their tax returns for paying tax on social security benefits, and see the line for disclosing income, they may well wonder what we in Washington will do to them next. Until the 1983 Social Security bill, the Congress had always rejected proposals to place a direct or indirect income tax on municipal bond interest. I think that this precedent will undermine the public's confidence in the continuing tax exemption for state and local bonds. If that happens, it will be the states and localities that will be hurt.

In the past, threats to the tax exemption were minimum taxes, targeted at the rich. This provision is even worse: it is targeted at the elderly middle class. Only individuals with less than $25,000 of adjusted gross income aside from their municipal bond interest ($32,000 for married couples) will be affected by this new law. Wealthy persons are not affected because persons with more than the $25,000 or $32,000 of adjusted gross income will already be paying the full tax on their social security benefits regardless of their municipal bond interest income.

So this is only a tax provision to strike at middle-income aged people. It is not one to strike at the wealthy.

In addition, the exempt interest rule adds a great deal of complexity to the formula for taxing social security benefits. The cost of administering this law, the cost of the complexity, the cost of adding additional lines on the income tax returns of elderly people—and the additional lines will probably have to go on everyone's income tax return—will in all likelihood completely offset the revenues that are estimated to be raised with the provision.

Why was this provision included in the 1983 Social Security amendments? As I recall the debate in the Finance Committee and the Senate floor earlier this year, proponents of including State and local bond interest in the tax base assumed that the provision was needed to close a loophole, under which a person could convert his taxable income into tax-exempt income in order to avoid paying tax on some of his social security benefits. In fact, the potential tax savings from such a conversion is very small and would be at least partly offset by the lower yield on the exempt bonds. The lower yield on exempt bonds, in fact, already acts as a kind of tax that operates to the benefit of the State or local Government. In the lower and middle tax brackets, this lower yield wipes out so much of the potential tax savings that there is little incentive for middle income people to own State and local bonds. For that reason, I believe that the revenue loss from this bill would be quite small—potentially much smaller than the estimates.

Let me also point out that the IRS has never asked for, or received, any information from the States or municipalities as to which persons receive tax-exempt interest. I wonder whether we now need to impose reporting requirements on our States and localities in order to help the IRS enforce this provision. That would certainly be a significant burden on the States and localities, but it might be necessary in order for the provision to be applied in an effective way.

Mr. Chairman, the remainder of my statement discusses the unconstitutionality of imposing the Federal income tax on State and local bond interest. The leading case in this area is *Pollock* v. *Farmers' Loan and Trust Company.* There were actually two *Pollock* decisions: the first invalidated portions of the 1894 income tax law, including the attempted taxation of State and local bond interest, and a second opinion, issued after rehearing, held that the entire tax law was unconstitutional.

The opinions written in the two *Pollock* decisions make it clear that Federal taxation of State and local bonds is unconstitutional. Under the cases, the Constitutional defect as to taxation of State and local bonds is that such a tax directly impairs the borrowing power of the States. The Supreme Court held that the Federal Government cannot, under our Constitution, impair this State and local borrowing power.

When the Sixteenth Amendment was taken up in Congress, the question of taxation of State and local bonds was not discussed and, as later events show, it was not contemplated that the amendment would permit taxation of State and local bond interest. When Charles Evans Hughes, then Governor of New York, raised the question during the ratification process of whether the 16th amendment would permit taxation of State and local bond interest, he was assured by Senators Borah and Brown that no such interpretation was possible. These comments may be found in the Congressional Record for February 10, 1910. The Record for March 1, 1910 contains similar reassurances in the form of a letter from Senator Elihu Root to a New York State Senator. Congressional debate on a proposal made during World War I to tax State and local bond interest also shows the congressional view that such a tax would be unconstitutional notwithstanding the 16th amendment, as does the fact that, in 1923, Congress considered adopting a Constitutional amendment to permit taxation of State and local bond interest. The 1923 proposed amendment passed the House but did not pass the Senate.

The precise question of taxing State and local bond interest has not been considered by the Supreme Court since the adoption of the 16th amendment. However, the Supreme Court has on several occasions, after the ratification of the 16th amendment, expressed the view that the Federal Government cannot tax State and local bond interest, citing the *Pollock* case as authority. On these occasions (involving cases on other subjects), the Court has distinguished the special case of bond interest from questions such as the taxability of Government contractors and employees by pointing out the immunity of the States' borrowing power from Federal taxation.

In view of the *Pollock* decision, its many citations since the ratification of the 16th amendment, and the legislative history of the amendment and of other related measures, it is clear that the tax on State and local bond interest contained in the Social Security Amendments of 1983 directly contradict a well-established Constitutional prohibition.

Congress should respect Constitutional limitations on the Federal taxing power and should not impose a tax such as this without new and express Constitutional authorization. This is especially so when the possibly unconstitutional provision is apparently unnecessary and otherwise imposes troublesome burdens of complexity on our senior citizens.

I hope that other Senators will support S. 1113, so that we can prevent this unwise and unconstitutional tax law from taking effect next year.

DESCRIPTION OF S. 1113

RELATING TO

THE USE OF TAX-EXEMPT INTEREST IN DETERMINING THE AMOUNT OF TAXABLE SOCIAL SECURITY BENEFITS

Scheduled for a Hearing

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY
AND INCOME MAINTENANCE PROGRAMS

OF THE

COMMITTEE ON FINANCE

ON

August 1, 1983

INTRODUCTION

The Subcommittee on Social Security and Income Maintenance Programs of the Senate Committee on Finance has scheduled a public hearing on August 1, 1983, on S. 1113, (sponsored by Senators D'Amato, Long, and others), providing that interest on obligations exempt from income tax would not be taken into account in determining the amount of social security benefits to be taxed.

The first part of this pamphlet is a summary of present law and the bill. The second part contains a description of present law, the issues raised by the bill, an explanation of the bill, estimated revenue effect of the bill, and examples of the effect of the bill on the amount of social security benefits included in gross income.

I. SUMMARY

Under the Social Security Amendments of 1983, beginning generally in 1984, a portion of social security and tier 1 railroad retirement benefits is included in the taxable income of recipients whose incomes, including 50 percent of benefits, exceed a base amount. The base amount is $32,000 for a married couple filing a joint return and $25,000 for an individual. The portion of benefits subject to tax equals the lesser of (1) one-half of the benefits, or (2) one-half of the excess of (a) the taxpayer's adjusted gross income increased by interest exempt from income tax plus one-half of the benefits, over (b) the base amount. Thus, interest exempt from income tax is taken into account in determining the amount of a recipient's benefits subject to tax. Interest exempt from income tax includes interest on obligations which are issued by or on behalf of a State or local government and which satisfy various other restrictions, including restrictions on the character of the facilities or services to be financed with the bond proceeds.

The bill would modify the provision dealing with taxation of benefits in the Social Security Amendments of 1983 so that interest exempt from income tax would not be taken into account in determining the amount of a recipient's social security and tier 1 railroad retirement benefits subject to tax.

The provisions of the bill would take effect as if included in the Social Security Amendments of 1983.

II. DESCRIPTION OF S. 1113

A. Present Law

Taxation of Social Security and Railroad Retirement Benefits

Prior to the Social Security Amendments of 1983 (the "Act"), social security benefits were not included in the gross income of recipients for Federal income tax purposes. Under the Act, a portion of social security benefits is included in the gross income of recipients whose adjusted gross incomes exceed certain levels, beginning generally in 1984.

Social security benefits included in the gross income of a taxpayer for a taxable year are equal to the lesser of (1) one-half of the social security benefits received, or (2) one-half of the excess of (a) the taxpayer's adjusted gross income (determined without regard to the deduction for two-earner couples and various exclusions of foreign earned income), increased by interest exempt from income tax plus one-half of the social security benefits received, over (b) the appropriate base amount. Thus, interest on obligations exempt from income tax is taken into account in determining the amount of an individual's social security benefits that is taxed.

The base amount is $32,000 in the case of a married individual filing a joint return; zero in the case of a married individual filing a separate return, unless he or she lived apart from his or her spouse for the entire taxable year; and $25,000 in the case of all other individuals.

A social security benefit is defined as any amount received by the taxpayer by reason of entitlement to either (1) a monthly benefit under title II of the Social Security Act (Federal Old-Age, Survivors, and Disability Insurance Benefits (OADSI)), or (2) a Tier 1 benefit under the Railroad Retirement Act of 1974. The Act also provides that social security benefits potentially subject to tax include any workmen's compensation the receipt of which caused a reduction in social security disability benefits.

For the purpose of determining the amount of social security benefits received during a taxable year, a taxpayer is permitted to reduce benefits received during the taxable year by the amount of benefits, previously received during the current or any preceding taxable year, that he repays during the taxable year. An elective, special rule also is provided for taxpayers who received lump-sum payments partially or fully attributable to prior years. If this special rule is elected, the taxpayer includes in gross income for the year in which the payment is received only the sum of the increases in gross income that would result from taking into account the appropriate portions of the lump-sum payment in the years to which they are attributable.

The proceeds from the taxation of benefits, as estimated by the Secretary of the Treasury, are transferred each quarter to the trust funds from which benefits are paid. An annual report from the Secretary concerning the transfers is required.

In general, the foregoing provisions apply to benefits received after December 31, 1983, in taxable years ending after that date. However, the provisions do not apply to any portion of a lump-sum payment received after December 31, 1983, if the generally applicable payment date of this portion is before January 1, 1984.

Obligations Exempt From Income Tax

Income tax treatment

Interest on State and local government obligations and on qualified scholarship funding bonds generally is exempt from Federal income tax (Code sec. 103).[1] However, obligations issued after June 30, 1983, must be in registered form in order for interest on the bonds to be exempt from tax. Additionally, exemption of interest on bonds whose proceeds are used for certain purposes is denied if certain Federally prescribed conditions are not met. Such bonds include industrial development bonds (IDBs), mortgage subsidy bonds, and arbitrage bonds.[2] Further, this exemption does not apply to capital gain realized on the sale or exchange of a bond.

Industrial development bonds (IDBs)

IDBs generally are bonds the proceeds of which are used in a trade or business other than a trade or business of a tax-exempt organization or governmental unit. Interest on IDBs is taxable unless the bonds are "exempt purpose" IDBs or "small issue" IDBs. Exempt-purpose IDBs are bonds issued to finance the following facilities: (1) projects for low-income residential rental property; (2) sports facilities; (3) convention or trade show facilities; (4) airports, docks, wharves, mass commuting facilities, or parking facilities; (5) sewage and solid waste disposal facilities, or facilities for the local furnishing of electricity or gas; (6) air or water pollution control facilities; (7) certain facilities for the furnishing of water; (8) qualified hydroelectric generating facilities; (9) qualified mass commuting vehicles; and (10) local district heating or cooling facilities. In addition, IDBs used to acquire or develop land as the site for an industrial park are exempt-purpose IDBs.

The proceeds of exempt small-issue IDBs may be used to finance any land or depreciable property, other than golf courses, country clubs, and other specified types or facilities, used in the trade or business of a taxable person. However, the aggregate face amount of the issue of which the bonds are a part may not exceed $1 million. The $1 million limitation is increased to $10 million where the aggregate amount of capital expenditures made by the user satisfies certain limitations. The small issue exception expires with respect to bonds issued after December 31, 1986.

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[1] Bonds issued by volunteer fire departments are treated as State and local government obligations if certain conditions are satisfied.

[2] Interest on arbitrage bonds is taxable. These bonds are obligations issued as part of an issue, all or a major portion of the proceeds of which are reasonably expected to be used (directly or indirectly) to acquire certain securities, the yield on which is reasonably anticipated to be materially higher than that of the bonds in the issue.

Mortgage subsidy bonds

An exemption from Federal income tax is provided for bonds issued to provide mortgage loans to certain purchasers of single-family residences (sec. 103A). Qualified mortgage bonds must satisfy various volume and targeting requirements and special arbitrage rules. The tax exemption for qualified mortgage bonds expires with respect to bonds issued after December 31, 1983.

Present law also exempts interest on qualified veterans' mortgage bonds. Qualified veterans' mortgage bonds are general obligation bonds, the proceeds of which are used to finance mortgage loans to veterans. Unlike qualified mortgage bonds, the tax-exemption for veterans' bonds does not expire after December 31, 1983, and these bonds are not subject to the volume, arbitrage, and most of the targeting rules applicable to qualified mortgage bonds.

Qualified scholarship funding bonds

Qualified scholarship funding bonds are obligations issued by not-for-profit corporations organized by, or requested to act by, a State or a political subdivision of a State (or of a possession of the United States), solely to acquire student loan notes incurred under the Higher Education Act of 1965. The entire income of these corporations (after payment of expenses and provision for debt service requirements) must accrue to the State or political subdivision, or be required to be used to purchase additional student loan notes.

Gift and estate tax treatment

A Federal gift tax is imposed on certain gratuitous lifetime transfers and an estate tax is imposed on certain transfers occurring by reason of death. The value of State and local government bonds is subject to the Federal gift and estate taxes.

B. Issues

One issue is whether an inequitable result would occur if certain taxpayers with substantial amounts of tax exempt interest were income to exclude all of social security benefits from tax while taxpayers with equal amounts of income from taxable bonds or other sources pay tax on some portion of benefits. The result is affected by the requirement under present law that interest exempt from income tax be taken into account in determining the amount of social security benefits to be taxed.

A second issue is whether the requirement is appropriate for, and effective in, preventing social security benefit recipients from reducing or avoiding taxation of benefits by investing in obligations yielding interest exempt from income tax, rather than taxable interest.

A third issue is whether the requirement under present law that interest exempt from income tax be taken into account in determining the amount of social security benefits to be taxed, constitutes taxation of tax-exempt interest, and, if so, whether the requirement violates the Constitution.

C. Description of the Bill

The bill would amend the provision in the Social Security Amendments of 1983 which provides for the taxation of social security benefits so that interest exempt from income tax would not be taken into account in determining the portion of social security benefits subject to income tax. Thus, the portion of social security benefits subject to tax would equal the lesser of (1) one-half of the benefits received, or (2) one-half of the excess of (a) the taxpayer's adjusted gross income (determined without regard to the deduction for two-earner couples and various exclusions of foreign earned income) plus one-half of benefits, over (b) the appropriate base amount.

Effective date.—The provision would take effect as if included in the Social Security Amendments of 1983.

D. Revenue Effect

The bill is estimated to reduce fiscal year receipts by $8 million in 1984, $31 million in 1985, $47 million in 1986, $63 million in 1987, and $83 million in 1988.

E. Examples of Calculation of Taxable Social Security Benefits

The effect of the bill may be illustrated with the following example. Under present law a taxpayer with $30,000 of tax-exempt interest and $8,000 of benefits would pay tax on half of benefits, i.e., $4,000; an equivalent result obtains for a taxpayer with $30,000 of taxable interest. Under the bill the first taxpayer would not include any benefits in adjusted gross income (AGI), while the second would continue to include $4,000. The remainder of this section explains the formula used to determine the portion of benefits included in AGI and includes more detailed examples of the effects of the bill on the amount of benefits to tax.

Examples Under Present Law

The table following presents six examples which illustrate how the taxable portion of benefits depends on the amount of income (other than benefits) received by the taxpayer. For all six examples, it is assumed that the taxpayer is an unmarried individual who receives $8,000 in benefits annually.

In example A, the sum of one-half of benefits ($4,000) plus other income (other adjusted gross income ($21,000) plus tax-exempt interest (none)) just equals the base amount ($25,000). Since the sum does not exceed the base amount, no benefits are included in adjusted gross income (AGI). Thus, for all taxpayers receiving $8,000 in benefits, $21,000 is the lowest amount of other income which may be received without paying tax on some portion of benefits. In general, all taxpayers for whom other income is greater than the base amount minus one-half of benefits must include some portion of benefits in AGI under present law.

In example B, other AGI is the same as in example A, but the taxpayer has $1,000 of tax-exempt interest. Half of benefits plus other income ($26,000) now exceeds the base amount by $1,000, and half of this excess ($500) is the amount of benefits included in AGI under present law.

Examples C and D are similar to A and B except that the taxpayers have $25,000 (rather than $21,000) of other AGI. The larger amount of other income leads to the inclusion of a larger amount of benefits in AGI. Example C illustrates the general rule that any taxpayer whose other income equals the base amount includes one-fourth of benefits in AGI.

In Example E, the sum of other AGI ($29,000), tax-exempt interest (none), and half of benefits ($4,000) equals $33,000, which exceeds the base amount by $8,000. Half of this amount, $4,000, is included in AGI. Since $4,000 also is half of benefits, however, this is the maximum amount of benefits included in AGI. This point is illustrated in example F, in which the taxpayer has $1,000 of tax-exempt interest in addition to other AGI of $29,000. Because half of benefits already is included in AGI, the additional income in the form of tax-exempt interest does not increase the amount of benefits subject to tax. In general, half of benefits is included in AGI for all taxpayers whose other income equals or exceeds the base amount plus half of benefits.

Examples of Amounts of Social Security Benefits Taxed

[Unmarried taxpayers receiving $8,000 per year of benefits]

	Example					
	A	B	C	D	E	F
1. One-half of benefits	$4,000	$4,000	$4,000	$4,000	$4,000	$4,000
2. Tax-exempt interest	0	1,000	0	1,000	0	1,000
3. Other adjusted gross income (AGI)	21,000	21,000	25,000	25,000	29,000	29,000
4. Sum of lines 1, 2, and 3	25,000	26,000	29,000	30,000	33,000	34,000
5. Base amount	25,000	25,000	25,000	25,000	25,000	25,000
6. Line 4 minus line 5	0	1,000	4,000	5,000	8,000	9,000
7. Amount included in AGI (lower of line 1 or one-half of line 6) under present law.	0	500	2,000	2,500	4,000	4,000
8. Amount included in AGI under S. 1113	0	0	2,000	2,000	4,000	4,000

Examples Under the Bill

Under the bill, taxpayers A and C would be unaffected, since they have no tax-exempt interest. Taxpayers B and D would have a tax reduction, since tax-exempt interest would not be used in determining the amount of benefits subject to tax. Thus, B and D would have the same amount of taxable benefits as A and C, respectively. However, taxpayer A and other hypothetical taxpayers whose other income is $21,000 or less would not be affected because their other income is low enough so that no benefits are taxable whether or not tax-exempt interest is taken into account. Also, taxpayer F would not be affected, since his other AGI is high enough so that half of benefits is included in AGI even without taking account of tax-exempt interest.

In general, therefore, the bill would reduce includible benefits for taxpayers who have some includible benefits under present law, who have tax-exempt interest, and whose other AGI is lower than the base amount plus half of benefits; these are the taxpayers for whom some, but less than half, of benefits would be taxed if tax-exempt interest were not used in the calculation. On the other hand, the bill would not affect taxable benefits for two groups of taxpayers—those whose other AGI plus tax-exempt interest is sufficiently low that taxable benefits are zero under present law and those whose other AGI is sufficiently high so that half of benefits would be taxed even if tax-exempt interest were not used in the calculation.

It should be noted, however, that these statements do not take into account any portfolio shifts and, thus, shifts in the amounts of other AGI and tax-exempt interest, which could occur if the bill were in effect. Depending on taxpayers' marginal tax rates, differences in yield between taxable and tax-exempt bonds, anticipated patterns of income in future years, and other factors, some taxpayers could change their holdings of tax-exempt bonds in response to the bill. Any such change would modify the analysis of the bill's effect on such taxpayers.

Senator ARMSTRONG. Our first witness is an authority on this subject. He has introduced legislation. And, in fact, this hearing this afternoon on this subject has been called at his request. So, Senator, we are delighted to have you with us, and we are at your disposal for almost, but not entirely, unlimited purposes.

STATEMENT OF HON. CARL LEVIN, U.S. SENATOR FROM THE STATE OF MICHIGAN

Senator LEVIN. Thank you very much, Mr. Chairman, Senator Long, Senator Matsunaga.

Phil Mastin, the Senator from Michigan, is here. I know I've met with him already today, but I think he thought this was scheduled for 3, so he may get here about then. I hope he's in time to say a few words to you because it is critical that you hear this.

Senator ARMSTRONG. We will take him whenever he gets here.

Senator LEVIN. Thank you.

Mr. Chairman, first I want to thank the subcommittee for the opportunity of testifying on the extended benefits program, and how it must be reformed if it is going to do the job which Congress originally intended for it to do. That job was stated over 10 years ago by Senator Long, as a matter of fact. I will get to that in a few moments in my testimony.

I also want to thank Senator Dole for his assistance in scheduling the hearing, as well as yourself, Mr. Chairman. It was scheduled, as you indicated, in reponse to a colloquy which I had with Senator Dole on the Senate floor in May. And Senator Dole's willingness to carry through with that is one of the series of sensitive steps that he's taken in the area of unemployment compensation.

First, Mr. Chairman, and others members of the committee, want to let the committee know of the anger and the confusion and the frustration of tens of thousands of people in my State of Michigan feel at seeing their unemployment benefits cut at a time when unemployment in Michigan still exceeds 15 percent. They hear the President say that the economy is recovering, but they are not recovering. They see industry, once again, as earning a profit, but they still are not earning a living. They know firsthand what anyone looking at all the recent data can see—unemployment is not a problem of the past. It is still a problem for the Nation, and that nation of ours will have over 9 percent unemployment for a long time to come, even by the President's own estimates. And it is still a problem for the people for whom the recovery is still a headline and not a paycheck.

As President Reagan has often said, "Unemployment is a lagging indicator." He should well understand, then, that the coming of the recovery does not remove the need for paying attention to the plight of the unemployed.

Here in Congress we work with formulas, we crunch numbers, we worry about legislative style. And we have to do all that. But through the eyes of almost one-half a million disillusioned and downtrodden people in the country, we have sacrificed compassion for the benefit of mathematical equations. It is impossible to go back to Michigan, which has endured over 40 months—that's over 3 years of double digit unemployment—and to tell people who have been unemployed for 37 weeks that they must risk the loss of their homes or their cars because of esoteric government formulas.

In May, Mr. Chairman, in May, Michigan's unemployment rate was 14.9 percent, and people were getting 53 weeks of unemployment benefits. In June, 1 month later, the unemployment rate in Michigan had risen from 14.9 percent to 15.2 percent, and people were eligible for 36 weeks of unemployment benefits. In other words, unemployment was worse that month in Michigan. It had actually gone up from June to May. But benefits were down by one-third. I don't believe that makes sense to anybody. I don't think it makes sense from anybody's perspective. And I challenge anyone to find the logic in that. Just like I challenge them to find any logic in the fact that for the past months Alaska and Wyoming have both been eligible for extended benefits even though they have had lower unemployment rates than did States like Michigan, Ohio, and Illinois, which have been cut off from extended benefits.

Furthermore, during the years 1975 and 1976, the last major recession in this country, the Nation had a lower rate of unemployment than we did today, but more States were eligible for extended benefits at that time than are eligible now. I would direct the committee's attention to the chart that demonstrates that anomaly. You can see that in 1975 and 1976, all 50 states were eligible for extended benefits although the unemployment rate, which is in gray shading, is between 7½ and 8½ percent, whereas in July 1982 through June and July 1983, our unemployment rate is significantly higher up in the area of 10 percent, and yet somewhere between 5 and 13 or 14 States are eligible for extended benefits.

So even though unemployment is much worse this recession than last time, the number of States that are elgibile for extended benefits has dramatically dropped.

Now when all these facts are taken together, it's clear that the people who are out of work in States of high unemployment have every reason to be angry, and every reason to ask, "What on Earth is going on there in Washington?" There's no question but that we should hear their voices and we should take action now to reform the extended benefits program.

Modifying the program is not only fair to the unemployed, it is necessary if the original intent of Congress is to be carried out. On August 7, 1970, when Senator Long was the floor manager of the very legislation which established the extended benefits program, he stated, 'The committee bill, like the House bill, would establish a new permanent program to pay extended benefits during periods of high unemployment to workers who exhaust their basic entitlement.' That was the statement of purpose by the floor manager, the very designer of this bill indeed. And I ask today would anyone claim Michigan, with an unemployment rate of 15.2 percent; Ohio, with an unemployment rate of 12.8 percent; Illinois, with an unemployment rate of 12.4 percent are not experiencing periods of high unemployment. But what all these States have in common is that none of them are eligible for the additional 13 weeks of unemployment compensation provided for by the extended benefit program, which was enacted in 1970.

Any discussion of the current state of the extended benefit program has to look to the changes made in the program as part of the reconciliation bill of 1981. In addition to repealing the national trigger by which all States could qualify for extended benefits if the national insured unemployment rate went above a certain level, the reconciliation bill made two other changes which have had a substantial effect on the number of States now eligible for the program. According to the Congressional Budget Office, if these changes had not been made, 21 States would have qualified for extended benefits for the week of July 2 instead of the five States which did qualify for the program during that week. And that chart simply shows that without those changes which we made as part of that reconciliation bill in 1981 and if the former rules had been in effect, 21 States would now be eligible because of those changes that were made in the trigger. But there's only five States that are now eligible for the extended benefits program.

Now the first of those changes was to raise the levels at which a State could become eligible for the extended benefit program. The second change modified the way in which the insured unemployment rate is calculated, so that it now no longer counts people who are receiving compensation under the extended benefits program as being among the unemployed. In other words, after you exhaust your State unemployment insurance, you are no longer considered unemployed for purposes of the extended benefit program. Logic might dictate the opposite. You are suffering more because you've been unemployed longer. But instead, we go at it the other way. We say once you have exhausted your State unemployment insurance, that first 26-week period, you no longer count.

Senator LONG. I'd like to ask a question. Isn't this what you are saying: "Once the Government has done all it is going to do for you, it wants to quit counting you and assume that you no longer exist"?

Senator LEVIN. That's what we are telling them. And it explains some of the anger in a number of States. These changes have largely contributed to the massive drop between April and June of the number of States eligible for extended benefits during a period when the national unemployment rate has shown only a very, very modest decline. Here I would ask that you look at the last chart which I have which portrays that situation.

The drop in unemployment from April to June of this year was from 10.2 percent to 10 percent, and yet the drop in the number of States on unemployment, on extended benefits, from April to June was from 22 to 8. And as that prior chart shows, it's from 22 to 5, if you look at July. Now there's a very, very minute drop in unemployment yet it's a drastic drop in the number of States eligible.

In reading over the material which OMB prepares, at the time these changes were proposed in 1981, it's hard to believe that the scope of what has happened with the extended benefit program was anticipated by the administration itself. Because in the words of the OMB document, entitled "Additional Details on Budget Savings," which was published in April of 1981: "The proposed shift to State triggers at modestly higher threshold levels will redirect benefits to areas where they are needed." That was the intention. It hasn't worked out that way. Because clearly it is needed in a State such as mine which has 15 percent unemployment. And yet that State is no longer eligible. Again, States like Ohio and Illinois which have higher unemployment rates than some States which are receiving this extended benefit are not eligible. So it's achieving its purpose.

So what the 1981 changes did were to both raise the bridge—by raising the insured unemployment rate—and to lower the river—by excluding the people receiving extended benefits from that IUR formula. Many of the unemployed have sunk in the process.

The conclusion which some have arrived at is that the changes enacted in the 1981 reconciliation bill should be suspended until national unemployment drops significantly below its current level. Frankly, I think that recommendation legitimately recognizes the fact that when the reconciliation bill was passed, it was not assumed that unemployment would rise as high as it has or that the extended benefit program would be needed as much as it is. But I also recognize the fact that attempts to suspend or repeal the 1981 changes have repeatedly met with defeat in the Senate.

And I, therefore, urge the committee to do something different. Not to change the formulas which have now been readopted twice by the Senate, but as an alternative, as a supplement to the existing two methods of being eligible to approve legislation along the lines of Senate bill 1589, which I have introduced with a bipartisan group of cosponsors.

This legislation has the goal of insuring that States actually do qualify for extended benefits if they are still enduring very high rates of unemployment as measured by the number of people who are looking for work but who cannot find it. In other words, the number of people actually unemployed. It would also qualify these States for the top tier of Federal supplemental compensation benefits.

This legislation would not—I emphasize—would not repeal any of the 1981 reconciliation bill changes, much as I would like to repeal some of those changes. Rather, it would provide an alternative mechanism for a State to qualify for extended benefits.

The additional trigger to qualify for extended benefits would be a TUR [total unemployment rate] of 11 percent. This rate looks to the number of people out of work but still looking for jobs. It, thus, differs from the insured unemployment rate, which is the current measure for the extended benefit program and which looks to the number of people who are out of work and receiving State unemployment benefits.

In the States for which the Bureau of Labor Statistics compiles seasonally adjusted data for the TUR on a month-by-month basis, the 11 percent trigger would be determined by looking at the most recently available TUR data in those States. This provision would cover the 10 most populous States in the Nation for which the statistical sample is large enough to make the TUR an accurate measure of the labor market conditions on a month-by-month basis.

In the remaining States and jurisdictions, the 11-percent trigger would be determined by looking to the 12-month rolling average of the TUR for those States, and by looking to the most recently available 1-month data. If the State's TUR is over 11 percent by both measures, it would be eligible for extended benefits. This two-pronged test is an attempt to make the measure timely, and to increase the sample size as well. In other words, we try to avoid creating a test which only some of the populated States could pass. We try to devise a test which all States would be eligible for on as fair a basis as we can possibly devise it. For the States that are too small to have a statistical sample large enough on a month-by-month basis, you would look at the last year for the statistical sample so that we could determine whether the actual unemployment rate was 11 percent or more.

This legislation would also require the Department of Labor to conduct a study to determine what common measure could be used for all 50 States and eligible jurisdictions to better reflect labor market conditions than does the IUR, the insured unemployment rate. I hope the committee will consider this and other approaches to make sure that the extended benefits program is more than an empty shell. That is what it has become for most of the unemployed of our country. They are angry with us. We should be angry at ourselves for allowing a program intended to help a large number of unemployed during periods of high unemployment fall victim to indifference and neglect.

Again, I thank the committee for the many courtesies that it has shown me. And for Senator Dole in particular for his help in helping to schedule this. And you, Mr. Chairman, and Senators Long and Matsunaga.

I would ask unanimous consent that the remainder of my statement now be included in the record. And that a statement from Senator Dixon be included in the record as well at this point.

Senator ARMSTRONG. We will be very happy to do that. And we are grateful for your statement.

[The prepared statements of Senators Levin and Dixon follow:]

TESTIMONY OF SENATOR CARL LEVIN

Mr. Chairman, I want to thank you for giving me the opportunity to testify before the Committee with respect to the Extended Benefit program and how it must be reformed so that it can do the job which the Congress originally intended it to do, I would like to thank Senator Dole for his assistance in scheduling this hearing in response to the colloquy which we had on the Senate floor during the debate on H.R. 2973. His willingness to do so is one of a series of sensitive steps he has taken in the area of unemployment compensation.

Mr. Chairman, I first met let this Committee know of the anger, the confusion, and the frustration which tens of thousands of people in my state of Michigan feel at seeing their unemplolyment benefits cut at a time when unemployment in Michigan still exceeds 15 percent. They hear the President say that the economy is recovering, but they are not yet recovering. They see industry once again is earning a profit, but they still are not yet earning a living. They know first hand what anyone looking at all the recent data can see—unemployment is not a problem of the past. It is still a problem for the nation, which will have over 9 percent unemployment for along time to come, even by the President's estimates. And it is still a problem for the people for whom the recovery is still a headline and not a paycheck. As President Reagan has often said, "Unemployment is a lagging indicator." He should well understand, then, that the coming of the recovery does not remove the need for paying attention to the plight of the unemployed.

Here in Congress we work with formulas, we crunch numbers, we worry about legislative style. And we have to do this. But through the eyes of almost half a million disillusioned and downtrodden people in the country, we have sacrificed compassion for the benefit of mathematical equation. It is impossible to go back to Michigan which has endured over 40 months of double digit unemployment and to tell people who have been unemployed for 37 weeks that they may risk the loss of their homes or their cars because of esoteric government formulas.

In May, Michigan's unemployment rate was 14.9 percent and people were getting 53 weeks of unemployment benefits. One month later, in June, the unemployment rate had risen to 15.2 percent, and people were eligible for 36 weeks of unemployment benefits. I challange anyone to find a logic in that, just like I challenge them to find any logic in the fact that for the past month Alaska and Wyoming have both been eligible for Extended Benefits even though they have had lower unemployment rates than did states like Michigan, Ohio, and Illinois which have been cut off from Extended Benefits.

Furthermore, during 1975/76, this nation had a lower rate of unemployment than we have today, but more states were eligible for Extended Benefits at that time than are eligible now. I would direct the Committee's attention to the chart which I had prepared that graphically demonstrates this anomaly. Since April of this year, the nationwide unemployment rate has barely fallen, but the number of states eligible for Extended Benefits has tumbled from 22 to 5.

When all of these facts are taken together, it is clear that the people who are out of work in states of high unemployment have every reason to be angry, and every reason to ask, "What on earth is going on there in Washington?" And, there's not question but that we should hear their voices and take action NOW to reform the Extended Benefit program.

Modifying the program is not only fair to the unemployed, it is necessary to allow the program to achieve the original intent of Congress. On August 7, 1970, when Senator Long was the floor manager of the legislation which establishes the permanent Extended Benefit program, he stated, "The committee bill, like the House bill, would establish a new permanent program to pay extended benefits during periods of high unemployment to workers who exhaust their basic entitlement." I ask today, would anyone claim that Michigan with an unemployment rate of 15.2 percent; Ohio with an unemployment rate of 12.8 percent; and Illinois with an unemployment rate of 12.4 percent are not experiencing "periods of high unemployment?" But what all of these states have in common is that none of them are eligible for the additional 13 weeks of unemployment compensation provided for by the Extended Benefit program enacted in 1970.

Any discussion of the current state of the Extended Benefit program has to look to the changes made in the program as part of the Reconciliation bill of 1981. In addition to repealing the national trigger by which all states could qualify for Extended Benefits if the national Insured Unemployment Rate (IUR) went above a certain level, the Reconciliation bill made two other changes which have had a substantial effect on the number of states now eligible for the program. According to the Congressional Budget Office, if these changes had not been made 21 states would have qualified for Extended Benefits for the week of July 2 instead of the 5 states which did qualify for the program during that week.

The first of these changes was to raise the levels at which a state could become eligible for the Extended Benefit program. The second change modified the way in which the Insured Unemployment Rate is calculated, so that it now no longer counts people who are receiving compensation under the Extended Benefits program as being among the unemployed.

These changes have largely contributed to the massive drop between April and June in the number of states eligible for Extended Benefits during a period when the nationwide unemployment rate has shown only a very modest decline. I direct the Committee's attention to next chart which I have had prepared which portrays this situation.

In reading over the material prepared by the Office of Management and Budget at the time these changes were proposed in 1981, it is hard to believe that the scope of what has happened with the Extended Benefit program was anticipated by the Administration itself. In the words of the OMB document entitled "Additional Details on Budget Savings" which was published in April of 1981: "The proposed shift to State triggers at modestly higher threshold levels will redirect benefits to areas were they are needed * * *" I ask again, could anyone's definition of "need" exclude a state like Michigan which has over 15 percent unemployment?

So what the 1981 changes did were to both raise the bridge—by raising the IUR levels—and to lower the river—by excluding the people receiving Extended Benefits from the IUR formula. Many of the unemployed have been asked to sink or swim, and too many have sunk.

The conclusion which some have arrived at is that the changes enacted in the 1981 Reconciliation bill should be suspended until nationwide unemployment drops significantly below its current level. I believe that this recommendation legitimately recognizes the fact that when the Reconciliation bill was passed, it was not assumed that unemployment would rise as high as it has or that the Extended Benefit program would be needed as much as it is. But I also recognize that attempts to suspend or repeal the 1981 changes have repeatedly met with defeat on the Senate floor.

I, therefore, urge the Committee to approve legislation along the lines of S. 1589, which I have introduced with a bipartisan group of cosponsors. This legislation has the goal of ensuring that states actually do qualify for Extended Benefits if they are still enduring very high rates of unemployment as measured by the number of people who are looking for work but who cannot find it. It would also qualify these states for the top tier of Federal Supplemental Compensation benefits.

This legislation would not repeal any of the 1981 Reconciliation bill changes. Rather, it would provide an alternate mechanism for a state to qualify for Extended Benefits.

The new trigger level to qualify for Extended Benefits would be a Total Unemployment Rate (TUR) of 11 percent. This rate looks to the number of people out of work but still looking for jobs. It, thus, differs from the Insured Unemployment Rate (IUR) which is the current measure for the Extended Benefit program and which looks to the number of people who are out of work and receiving state unemployment benefits.

In the states for which the Bureau of Labor Statistics compiles seasonally adjusted data for the TUR on a month-by-month basis, the 11 percent trigger would be determined by looking to the most recently available TUR data in those states. This provision would cover the 10 most populous states in the Nation for which the statistical sample is large enough to make the TUR an accurate measure of the labor market conditions on a month-by-month basis.

In the remaining states and jurisdictions, the 11 percent trigger would be determined by looking to the twelve month rolling average of the TUR for those areas, and by looking to the most recently available one month data. If the state's TUR is over 11 percent by both measures, it would be eligible for Extended Benefits. This two pronged test is an attempt to make the measure timely and to increase the sample size as well.

This legislation would also require the Department of Labor to conduct a study to determine what common measure can be used for all 50 states and eligible jurisdictions to better reflect labor market conditions than does the IUR.

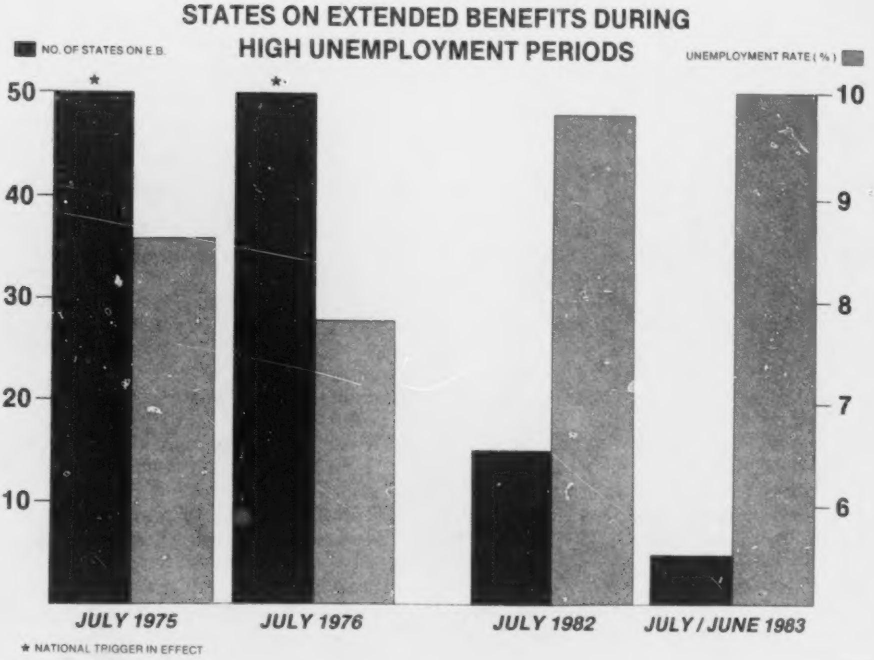
I urge the Committee to consider this and other approaches to make sure that the Extended Benefit program is more than an empty shell. That's what it has become for most of the unemployed of our country. They are angry with us—we should be angry at ourselves for allowing a program intended to help a large number of unemployed during periods of high unemployment to fall victim to indifference and neglect.

Mr. Chairman, I would also like to bring to the attention of the Committee another problem which has arisen with respect to the receipt of Extended Benefits and Federal Supplemental Compensation. It has put workers in a position that has left them embittered and disillusioned.

Michigan has endured over 40 consecutive months of double digit unemployment. In that setting, some workers who were fortunate enough to be temporarily recalled to work, have found themselves thrust back into a slow job market, if they were subsequently once again laid off. What has left these workers embittered is the fact that after they were laid off for the second time, they could not resume receiving Extended Benefits or Federal Supplemental Compensation. The reason that this situation has arisen is that their temporary employment had been long enough to carry them beyond their "benefit year," during which time they could have resumed receiving unemployment benefits after their temporary recall had ended, but not long enough to meet the eligibility requirement of 20 weeks of work for Extended Benefits or Federal Supplemental Compensation. Therefore, many of these workers feel that they have been penalized for having had the initiative to go back to work at the first chance open to them.

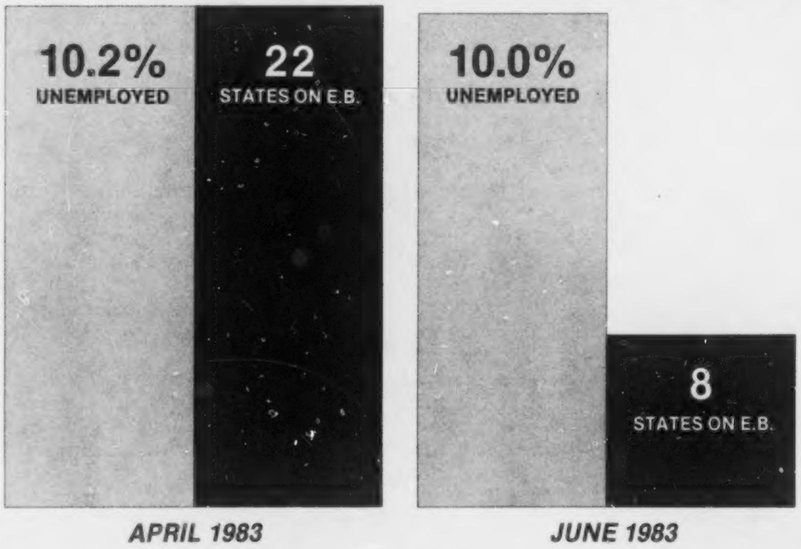
I believe that their concerns are legitimate and merit the Committee's attention. I would ask that in its review of the Extended Benefit program and Federal Supplemental Compensation program, the Committee consider modifying the 20 week requirement so that it refer to either of the two most recent periods of work prior to a person's becoming unemployed. This would assure that a worker who has had a steady history of work, followed by a substantial period of unemployment only temporarily interrupted for a short work period, will not re-enter the ranks of the unemployed without the possibility of resuming receipt of their remaining entitlement for Extended Benefits or Federal Supplemental Compensation.

If we are going to encourage people to look for work, we should not penalize them for their initiative. Legislation along these lines would be a step in this direction.



STATES ON EXTENDED BENEFITS DURING HIGH UNEMPLOYMENT PERIODS

NATIONWIDE UNEMPLOYMENT & THE NUMBER OF STATES ELIGIBLE FOR EXTENDED BENEFITS



STATEMENT OF SENATOR ALAN J. DIXON

I would like to take this opportunity to thank the distinguished Chairman of the Subcommittee, Senator Armstrong, for holding hearings on S. 1589, a bill to provide alternative state unemployment triggers, which is a matter of deep concern to many of us.

The broader issue is our unemployment insurance system. To call it a system is somewhat of a misnomer, because it does not function smoothly and effortlessly. We have to keep tinkering with it. Many of us have been involved in the band-aids which have been applied to this "system." But our ultimate goal, I believe, is to serve people who need our help. I know that you all are aware of the situation in which we find ourselves today. That is why we are participating in this hearing. However, for the record, I would like to give the perspective of my State of Illinois, and others in similar circumstances: states with high total unemployment rates or TUR, and ever decreasing insured unemployment rates, or IUR.

As you know, Illinois, Michigan, Ohio and many other states have triggered off extended benefits or EB. In fact, only five states remain eligible to pay these benefits.

We have attempted to address this issue many times in the past year. Several members of the Finance Committee have joined in such efforts.

My State of Illinois is no longer eligible to pay EB under the existing formula, because we have dropped to an IUR of 5.22 percent, which is 114 percent of the prior two years. As you know, the requirement is 6 percent or 5 percent if the rate is 120 percent of the prior two years.

What this means in real terms, is that during the third week of June, an unemployed worker who qualified for the maximum benefits available could be assured of protection under the formula for a total of 53 weeks of benefits, including 26 weeks of regular benefits, 13 weeks of EB and 14 weeks of federal supplemental compensation or FSC.

With the drop in the IUR during the fourth week in June, that same unemployed worker would be eligible for only 38 weeks of coverage.

I think it is worth reviewing the circumstances leading up to the implementation of the FSC program last September. Then, as now, states with the highest total unemployment rates in the country were triggering off EB.

The FSC program was adopted to cope with this problem, since the trigger increases implemented by the Reconciliation Act of 1981 were becoming effective at that time, and repeal, although attempted, of that and the change in calculating the IUR was not possible.

The FSC answer was meant to assure that unemployed workers in those states which had triggered off would still receive the same number of weeks of benefits to which they were entitled before the state became ineligible to make payments. You will recall the "grandfathered" states and the major attempts made to accommodate everyone who had an interest in the matter.

In the present situation in which we find ourselves, however, unemployed workers in Illinois, as well as others who were at one time eligible for EB will receive one week less of FSC that they used to under EB, and will shortly slip to three weeks less.

The FSC program, as it is currently structured, allows the maximum benefits to be paid to unemployed workers in states with an insured rate over 6 percent. Therefore, we experience a double penalty: no EB and two weeks less of FSC.

What do we tell our unemployed workers who depend on these benefits when they ask why they are only eligible for 38 weeks of benefits? Statistics don't provide an answer in situations like this. These people are looking for a way to keep a roof over their heads. They are looking for a way to continue to meet their basic needs for survival. yet we are forced to tell them that the law is the law, and we're sorry, but that's the way it is.

It doesn't have to be that way. It wasn't always that way. In 1971, under President Richard Nixon, there was a temporary extension of the EB program to 52 weeks in states with insured unemployment rates in excess of 6.5 percent. That was at a time when the national unemployment rate was only 6 percent.

In 1974, under President Ford, there was a 26-week FSC program, offering a total of 52 weeks of coverage, at a time when the national unemployment rate was only 7.1 percent.

In 1975, there was a total of 65 weeks available, when the national unemployment rate rose to 8.8 percent.

Those past levels of single digit unemployment look pretty good when faced with 10 percent as of June of this year. But when you consider the states with unemployment rates in excess of 11 percent, it becomes apparent that we not addressing the matte in the compassionate way that our colleagues did in the past.

The Administration has estimated that only four states will be eligible to pay EB by the end of the year. I wish we could say this is because only four states out of 50 would be experiencing serious levels of unemployment. Unfortunately, that will not be the case.

Our bill offers a new approach to this dilemma. It doesn't repeal existing law. It merely allows an opportunity for states to qualify for the EB program and the maximum weeks of FSC based on total unemployment rather than insured unemployment.

If a state has had over 11 percent unemployment, surely that is a sign of distress. Our bill would alleviate that distress by allowing a state the option of using a different method of qualifying for EB, if a state cannot meet the current triggers, and 14 weeks of FSC. Estimates indicate that eight states have or soon will trigger off EB, while at the same time suffering an unemployment rate in excess of 11 percent. That doesn't make sense!

By addressing the problem as S. 1589 does, we are assuring that states with the greatest need are able to pay the total allowable number of weeks of benefits. That does make sense!

It is truly unfortunate that we must continue to deal with this system in a piecemeal fashion. The Federal-State Unemployment insurance programs are patched up whenever as emergency presents itself. I am grateful to have this opportunity to express the sentiment of many who would like see this unwieldy situation changed. The system should truly be a system which responds in critical times. It does not do that now.

We look forward to working with this Committee to find a solution to this recurring problem, so that at long last we can provide some real answers. It is time to tell the millions of unemployed in this country that our laws can respond to them, that the system works and that we understand.

Senator ARMSTRONG. Senator Long, do you have anything you would like to raise?

Senator LONG. Where does Louisiana stand on those charts that you have got there? I regret to say Louisiana has been moving up in those columns of unemployment. Do you have some information as to where Louisiana stands on the unemployment charts now?

Senator LEVIN. Mr. Long, as I understand it, Louisiana is going to trigger off extended benefits, but would be eligible for most quarters if we adopted my approach.

I understand that it is one of the five states, but that it is going to trigger off extended benefits.

Senator LONG. Well, I'm not particularly proud about the high level of unemployment. I'm certainly not happy about it. But, unfortunately, it has a lot to do with the fact that there have been such major cutbacks in exploration for oil and gas. Louisiana now has been moving up the list. We are something like No. 6 in unemployment. Is that to your recollection?

Senator LEVIN. I'm not sure what number you are. I misunderstood your question. I thought you were asking me whether or not you were going to continue to be eligible for the extended benefits program. And it's my understanding you are not going to be eligible much longer for the extended benefits program. You are high up on the list, but I don't know the exact number.

Senator LONG. Thank you.

Senator ARMSTRONG. Senator Matsunaga.

Senator MATSUNAGA. I congratulate you on the leadership you have assumed in this regard, Senator Levin. Whether an unemployed worker comes from a State with an unemployment rate of 11.1 percent or whether he comes from a State with, say, 9 percent, would he and his family not be in as much need for extended benefits as the one from a State with unemployment in excess of 11 percent.

Senator LEVIN. I think he would be, and that's why at some point we had a national trigger for the extended benefits program, and everybody was eligible for it. One of those charts indicated all

50 States were eligible in the earlier recession we were talking about. I agree with you. But if we are not going to do it that way, at least let's have the extended benefits program go to where the unemployment is highest.

I happen to agree with you. If you are unemployed, you are unemployed. And your need is great whether your unemployment rate is 6 percent or 8 percent in your State. But we have decided to target some of these programs. And if we are going to target, at least let's target in a logical way. Our present system makes no sense. We have got States with some of the highest unemployment in the country that are not on the extended benefits program at the very instant that States with lesser unemployment are on the extended benefits program. So from neither sense does it make logic.

Senator MATSUNAGA. Thank you. That's the point I was trying to make.

Senator ARMSTRONG. Senator Levin, we've got a number of witnesses who are going to talk on this subject. Would you join us up at the table?

Senator LEVIN. Thank you.

Senator ARMSTRONG. And if your time permits, we would welcome your staying and participating in the balance of the hearing on this subject.

Senator LEVIN. Thank you so much, Mr. Chairman. As I indicated, Mr. Senator Mastin is here now. I see Senator Riegle is also here. And he will take over the introduction. And as I indicated, Senator Mastin did not know there was a change in schedule here.

Senator ARMSTRONG. Well, there really isn't a change in the schedule. We are just sort of ad hocing it along as people show up.

Thank you very much, Carl.

Senator LEVIN. Thank you.

Senator ARMSTRONG. We would like to recognize our colleague, Senator Don Riegle, of Michigan who, I believe, is going to introduce a member of the Michigan State Senate. And perhaps just to facilitate everybody's schedule, Mr. Mastin, if your schedule would permit you—I understand you have got a 5:40 plane?

Senator MASTIN. Hopefully, yes.

Senator ARMSTRONG. Is that right? I thought I would take Mr. Riegle next, and then revert to our actual public schedule and take Carolyn Golding, and then come back to you.

Senator MASTIN. That would be fine.

Senator ARMSTRONG. We are just trying to get everybody in the best we can.

Senator Riegle, we are delighted to welcome you; and eager to hear from you.

THE HONORABLE DONALD W. RIEGLE, U.S. SENATOR FROM THE STATE OF MICHIGAN

Senator RIEGLE. I thank the Chairman, my friend who is my colleague from the House days and now Senate days. It's a pleasure to appear before you and also Senator Long and Senator Matsunaga.

Let me say at the outset that I appreciate very much the fact that the subcommittee is zeroing in on the issue of the Federal-

State extended benefits program. I have a rather lengthy and detailed statement that I want to submit for the record, and not burden the committee unduly in terms of reading it into the record.

Senator ARMSTRONG. Of course. We will be very happy to have it for the record.

[The prepared statement of Senator Riegle follows:]

TESTIMONY OF SENATOR DONALD W. RIEGLE, JR.

Good afternoon, Mr. Chairman. I am pleased to have the opportunity to testify before your subcommittee concerning the Federal-State Extended Benefits (EB) program. This program has proven extremely important in Michigan where thousands of workers have exhausted their regular benefits but have been unable to secure employment. Unfortunately, Michigan has triggered off this program for the second time in the past two years despite having the second highest rate of unemployment in the nation. I hope this hearing will aid all of our understanding of this unfair situation and will lead to legislative solutions to correct it.

One person who can give you an accurate depiction of how the EB program malfunctions in Michigan appears on today's witness list. He is Philip Mastin, distinguished member of the Michigan Senate and Chairman of the Michigan Senate Labor Committee. Phil has served the State of Michigan very well for several years. He served as a State Representative for the 69th District between 1971 and 1976 and currently represents the 8th District in the State Senate. He has received several awards and has authored several studies of interest to Michigan. One of these publications concerns the problems of the unemployed workers in Michigan. Because of his special knowledge in this area, I am sure that you will find his remarks enlightening. It gives me great pleasure to introduce Senator Mastin to this subcommittee this afternoon.

Mr. Chairman, I think it would be beneficial for us to consider the original purpose for enacting the EB program and how the current program fails to reach the group of people for which it was created. This problem, I believe, derives from legislative tinkering with the program as a part of this Administration's budget slashing agenda. While Congress has proven unwilling to undo much of this tinkering, I am hopeful that the Finance Committee will be receptive to various solutions that are proposed this afternon.

PURPOSE

As you know, Mr. Chairman, the EB program constitutes the second tier of the three tier unemployment insurance system. It provides up to 13 weeks of benefits to jobless workers after they exhaust their regular state benefits in states that qualify (or are "triggered on") for the program. The Federal and state governments finance these benefits equally through the imposition of unemployment taxes on employers. Congress permanently authorized the EB program with the Federal-State Extended Unemployment Compensation Act of 1970 (P.L. 91-373).

In enacting the EB program, Congress found that during recessionary periods the regular state unemployment insurance programs were not adequately meeting the primary unemployment insurance objective of providing temporary and partial wage replacement for involuntarily unemployed workers. Data indicated that while 26 weeks of regular state benefits provided adequate wage replacement protection during periods of low unemployment, they were insufficient during periods of high unemployment. Since the average length of a temporary period of unemployment increases with a deterioration in economic conditions, Congress found that an increase in the duration of benefit protection during this period constituted an appropriate response to the problem.

The extended benefit program was crafted so as to meet the dual objectives of providing additional protection during economic downturns while insuring that the additional protection was not in effect during healthy economic periods. In order to meet this latter objective, a triggering mechanism was necessary so that extended benefits were triggered only when adverse unemployment conditions existed. Consequently, the EB program was structured to take effect only when the insured unemployment rate (IUR) was high enough to indicate severe economic downturns. The IUR measures the ratio of unemployed workers receiving unemployment benefits to those covered by the unemployment insurance laws.

While Congress was concerned that the program not remain in effect after recessionary periods had ended, it also sought to insure that extended benefits did not terminate prematurely and did not go into effect too late, when another recessionary period began. It modified the triggering mechanism several times during the 1970's in order to meet these objectives.

Congress created the National Commission on Unemployment Compensation in 1976 to conduct a thorough review of the Federal-State Unemployment Compensation system. In its July, 1980 report, the Commission concluded that the EB program had "clearly demonstrated its economic and social desirability" in providing additional unemployment benefits during recessionary periods. Consequently, it recommended that the program be retained as a permanent part of the unemployment insurance system.

RECENT EXPERIENCE IN MICHIGAN

As you are aware, Mr. Chairman, the serious recession that has gripped this country during the past three years has been felt especially keenly in the state of Michigan. Double digit unemployment has ravaged Michigan for the past 42 consecutive months. Hundreds of thousands of jobless Michigan workers have engaged in fruitless job searches in their communities. It has been exactly the type of severe economic recession against which the EB program was designed to provide protection. While jobless Michigan workers have qualified for extended benefits for many months of this severe recession, a disturbing fact remains that Michigan has twice triggered off the program in the midst of depression-like conditions.

In October of 1981, Michigan triggered off the EB program despite having the highest unemployment rate in the nation. The law required Michigan to remain off the program for 13 weeks despite increasing unemployment during this period.

This year Michigan's (seasonally adjusted) unemployment rate in June stood at 15.2 percent when it once again triggered off EB. Only West Virginia suffered from a higher rate. Approximately 661,000 Michigan residents were counted as officially unemployed. Sadly, that figure doesn't even include the thousands of "discouraged" workers who have dropped out of the labor force since they consider a job search to be fruitless. Despite this massive unemployment in June, Michigan once again triggered off the EB program on the eleventh day of that month. On that date, nearly 57,000 jobless Michigan workers were dropped from the EB program. Clearly, the objective underlying EB program is not met when the state with the highest or second highest unemployment rate cannot even qualify for the program's assistance.

The question thus becomes why has this unfair situation developed? I submit, Mr. Chairman, that this situation has developed as a direct result of irrational changes made in the EB program at the behest of the Reagan Administration.

CAUSES

The changes to which I refer occurred with the passage of the Omnibus Budget Reconciliation Act of 1981, which made severe cuts in the unemployment insurance program by tightening eligibility requirements. The Administration told us at that point that the changes were necessary in order to balance the budget and to reflect the lower unemployment rate that the Administration predicted. The past two years, which have provided us with the highest budget deficit in history and the highest unemployment in decades, have made a mockery of this justification.

The Reconciliation Act made three important changes in the EB program. First, it eliminated the national trigger system so that only individual state trigger mechanisms remained. Second, effective on October 25, 1982, it increased by a full percentage point the level of insured unemployment required to trigger the payment of extended benefits in a state. As a result of that change, a state qualifies for the EB program only if its IUR equals or exceeds 6.0 percent or its IUR equals or exceeds 5.0 percent and is at least 20 percent greater than the average of the same period in the prior two years. No justification exists for this increase other than to deny more jobless workers these needed benefits.

The most serious change made by that Act, Mr. Chairman, concerns the calculation of the insured unemployment rate. Prior to that Act, the IUR included individuals receiving unemployment benefits under the regular and the EB program. As a result of that Act, individuals receiving extended benefits were dropped from that calculation. As I have said many times since 1981, exclusion of these unemployed from the IUR calculation simply makes no sense. The unemployed worker collecting benefits in his 30th week of unemployment faces the same predicament as the one collecting benefits in his 25th week of unemployment—both are unemployed. Since both qualify for unemployment benefits, the distinction made between the two under current law is illogical.

The exclusion of individuals receiving extended benefits penalizes states with many long term unemployed in an arbitrary and unfair manner. The industrial Midwest has suffered through this serious recession for longer than any other region of the country. In Michigan, which has recorded three and one half years of double digit unemployment, many workers who lost their jobs have remained unemployed for extraordinarily long periods of time because of an absence of job opportunities. Since the IUR excludes every unemployed worker after he has drawn 26 weeks of benefits, it is not surprising that the IUR has declined quickly in Michigan. The declining IUR should indicate an improved employment picture. This is simply not the case, however, in Michigan or other industrial Midwest states. Rather, the IUR has ceased to reflect accurately my state's unemployment problem.

The statistics depict this bizarre situation. While the Michigan IUR dropped almost a full percentage point in June, the regular unemployment rate (seasonally adjusted) actually increased. An enormous gap has developed between the regular unemployment rate and the IUR. That gap in Michigan at the end of June had grown to over 10 percent, (15.2 percent v. 4.75 percent). Nationally the gap has grown from 0.8 percent in 1950 to 5.8 percent in March of this year.

We have thus reached a situation where the measure that determines a state's eligibility for the EB program does not reflect a state's unemployment problems. Since the primary objective of the EB program is to provide benefits in states experiencing high unemployment, tying eligibility for the EB program to the IUR no longer makes any sense. If we in Congress believe in the value of an extended benefit program as I believed we should, let's insure that the program reaches those it was designed to help.

SOLUTIONS

I introduced legislation during the last Congress and have cosponsored legislative efforts during this Congress to repeal the unemployment insurance changes made by the 1981 Budget Reconciliation Act. I continue to believe that the increase in trigger rates was unwarranted and that the change in calculation of the IUR defies logic. If we are to cut the amount of Federal outlays, we should not do it at the expense of those long term unemployed who find themselves without jobs through no fault of their own.

Repeal of the 1981 changes has thus far not proven popular in the Senate. Consequently, I would suggest that this subcommittee seriously consider the use of the regular unemployment rate to determine eligibility for the EB program. Senator Levin has proposed this solution in S. 1589, which would retain the IUR but grant a state the option of using its regular unemployment rate to qualify for the EB program. Since the statistics indicate that the IUR often fails to reflect accurately a state's serious unemployment problem, Senator Levin's bill constitutes a commendable solution.

Mr. Chairman, while this hearing concerns the EB program, I would point out that the IUR also determines the number of benefit weeks that a state qualifies for under the Federal Supplemental Compensation (FSC) program. The same problems associated with the use of the IUR to determine EB eligibility exist with the FSC program. Long term jobless workers in Michigan have lost 4 weeks of FSC benefits during June despite an increase in the regular unemployment rate during that month. I would hope that this subcommittee would address this problem as a part of this hearing. Moreover, I would urge the full Finance Committee to schedule hearings concerning the extension of the FSC program as soon as possible. The program is scheduled to expire at the end of September and long term unemployed workers have already begun to exhaust the benefits provided under that program.

Mr. Chairman, I hope that this hearing will result in changes in the eligibility requirements for the EB program. Assistance in the form of unemployment benefits has proven extremely important to the millions of unemployed American workers during the past three years. Unfortunately, these benefits reach a significantly smaller percentage of the unemployed today despite the highest levels of unemployment in decades. While 81 percent of the unemployed qualified for assistance in April, 1975, only 41 percent qualified for assistance this June. Hearings such as this one will provide us with a better understanding of why fewer unemployed receive help from these programs. I appreciate the diligence with which this Committee has acted to address problems in the various unemployment insurance programs. I am hopeful that this subcommittee and the full committee can agree to a solution to the problems that now affict the Extended Benefits program.

Senator RIEGLE. If I may, then, I want to give a brief summary prior to introducing Senator Mastin.

I think it is fair to say that the extended benefits program has proven extremely important in Michigan for thousands of workers who have exhausted their regular benefits and who have been unable to secure employment after that point.

Unfortunately, Michigan, has triggered off this program for the second time in the past 2 years despite the fact that we have the second highest unemployment rate in the Nation.

I hope this hearing will help us determine why this kind of an unfair situation develops and how we can correct it. While the Michigan insured unemployment rate dropped almost a full percentage point in June, the regular unemployment rate, seasonally adjusted, actually increased. An enormous gap has developed between the regular unemployment rate and the insured unemployment rate.

To give you an illustration, the gap in Michigan at the end of June had grown to over 10 percentage points so that our unemployment rate in terms of actual unemployment is 15.2 percent, while our insured unemployment rate is calculated as only 4.75 percent. Nationally the gap has grown from less than a percentage point in 1950 to 5.8 percent in March of this year. So this problem, while it is very extreme in the case of our State, is increasingly a problem for the Nation as a whole.

We've reached the situation today where the measure that determines the State's eligibility for the extended benefits program does not really reflect the State's unemployment problem. Since the primary objective of the extended benefits program is to provide benefits to States experiencing high unemployment, tieing eligibility for the extended benefits to the insured unemployment rate really no longer makes any sense.

If we, here in the Congress, believe in the value of an extended benefit program, as I believe we should, then I think we have to make sure that that program reaches those it is actually designed to help.

I've introduced legislation in the last Congress and cosponsored legislative efforts in this Congress to repeal the changes that were made in the unemployment insurance area in the 1981 Reconciliation Act, and that legislation, of course, is before you.

But I want now, if I may, to introduce to you a person who probably is the best expert that we could find at the State level to deal with what this problem actually concerns: unemployed workers and their families. This is Senator Philip Mastin, who is a distinguished member of the Michigan Senate, and serves there as chairman of the Michigan Senate Labor Committee.

Senator Mastin has served the state of Michigan very well for many years. He served as a State representative from 1971 until 1976. He currently represents one of the most economically disadvantaged areas in terms of the hardship of unemployment in the State, the Eighth District of Michigan. He has received many awards, and has authored many studies on the problem of unemployment and unemployed workers. So he brings a special knowledge to this area. I think you will find him to be an expert witness in the full sense of the word. I am anxious for him to have the chance to share those views with the committee.

Senator ARMSTRONG. Thank you very much, Senator Riegle. Unless either Senator Long or Senator Matsunaga has something for you, let me invite you also to join us up here at the table for the rest of the hearing if your schedule permits.

Senator Mastin, we are happy to have you here. If you don't mind, we are going to go ahead now and pick up Carolyn Golding's testimony, and then we will back to you in just a moment.

Senator MASTIN. Thank you. I will be happy to stand aside.

Senator ARMSTRONG. Thank you very much.

We are now pleased to hear from Carolyn Golding, the Director of Unemployment Insurance Service, Department of Labor.

STATEMENT OF CAROLYN GOLDING, DIRECTOR, UNEMPLOYMENT INSURANCE SERVICE, DEPARTMENT OF LABOR, WASHINGTON, D.C.

Senator ARMSTRONG. Thank you for coming to be with us. And for letting us adjust the schedule a little as we go on. Please submit your testimony in whatever way seems best to you.

Ms. GOLDING. Thank you, Mr. Chairman.

I am Carolyn Golding, Director of the Unemployment Insurance Service of the U.S. Department of Labor. I am accompanied today by James Van Erden, supervising actuary for the Unemployment Insurance Service.

I have submitted some written testimony for the record. And with your permission, I would like to make a few key points before we move to questions.

Senator ARMSTRONG. Thank you very much. Please do.

Ms. GOLDING. We are pleased to be here today to talk about the extended benefits program and the changes that were made in that program by the Omnibus Reconciliation Act of 1981. Basically, there were four major changes made in the extended benefits program.

First of all, the national trigger was eliminated. Second, the State trigger levels were increased from 4- and 5-percent insured unemployment rates to 5- and 6-percent insured unemployment rates.

Third, the 1981 changes limit extended benefits to claimants with at least 20 weeks of work in their base period.

And, finally, as we have heard, the calculation of the insured unemployment rate was changed so that it would include only individuals filing regular State UI claims in the count.

Those changes have had several important effects. First of all, States with low insured unemployment rates did not pay extended benefit claims as they would have if the national trigger had been continued. Instead, in fiscal year 1982, 34 high insured unemployment rate States did trigger on to extended benefits. And in 1983, 31 States have triggered on.

Claimants in those States will have received about $4.1 billion in benefits during fiscal years 1982 and 1983. Thus, extended benefits have been more highly targeted to high insured unemployment rate States.

A second major effect is that the extended benefits program now emphasizes its insurance nature by paying benefits only to workers who have a substantial work history or an attachment to the labor force.

Third, removing extended benefits claims from the calculation of the insured unemployment rate means that extended benefits periods are not artificially prolonged in times when unemployment may be less than when extended benefits first triggered on. Similarly, removing extended benefits claims from the calculation permits States which have paid extended benefits in the prior 2 years to trigger on sooner if their economy declines. This has happened to 10 States since the enactment of the Omnibus Reconciliation Act changes of 1981.

Finally, since the 1981 changes to extended benefits, Congress has enacted a Federal supplemental compensation program. That program now operates in all 53 States. In fiscal years 1982 and 1983, claimants received over $5.4 billion in benefits under that program

Mr. Chairman, that concludes my remarks. We will be glad to try to respond to your questions.

Senator ARMSTRONG. Thank you very much.

[The prepared statement of Ms. Carolyn Golding follows:]

STATEMENT OF CAROLYN M. GOLDING, DIRECTOR, UNEMPLOYMENT INSURANCE SERVICE, EMPLOYMENT AND TRAINING ADMINISTRATION, DEPARTMENT OF LABOR

Mr. Chairman and Members of the Committee, I am Carolyn M. Golding, Director of the Unemployment Insurance Service of the Employment and Training Administration, Department of Labor. I am accompanied by James Van Erden, Supervising Actuary.

We have been asked to comment on the results of the changes in the Federal-State Extended Benefit program that were effected in the Omnibus Budget Reconciliation Act of 1981 (OBRA-81). These changes were:

(1) Eliminate the national trigger so that extended benefits became payable only in States with the required insured unemployment rates provided in Federal law.

(2) Exclude extended benefit claims from calculation of State insured unemployment rates (IUR) for extended benefit triggers.

(3) Raise State extended benefit triggers from 4 percent IUR (mandatory) and 5 percent (optional) to 5 percent (mandatory) and 6 percent (optional).

(4) Require that States limit payment of extended benefits to claimants who have at least 20 weeks of full-time employment or the equivalent in wages in the State's 12-month base period.

Purposes in proposing these changes were to:

Continue protection for long-term unemployed while strengthening the basic insurance concept;

Target the benefit dollars to States whose workers need this extra help;

Recalibrate the triggers of the extended benefit program to States with high and persistent unemployment but to avoid continuing such payments in times when unemployment may be less than when payments began;

Strike a balance between needs of the unemployed workers and the need to avoid ballooning Federal and State deficits; and

Ensure that funds go to workers with firm labor force attachment.

This is how these purposes were accomplished:

OBRA-81 eliminated the national trigger and targeted extended benefits to those States whose workers were most in need of such extra help. A State with low unemployment, for example, is not triggered "on" by other States with high unemployment. It is triggered only by its own insured unemployment rate.

OBRA-81 also increased the rate of insured unemployment necessary to trigger on extended benefits in an individual State. This change, to 5 percent and 6 percent, respectively, from the prior 4 percent and 5 percent requirements, was designed to return the extended benefit program to its original concept of targeting benefits to areas of relatively high unemployment, in light of the fact that residual levels of unemployment have risen after each of the post-World War II recessions and recoveries. Even after the elimination of the national trigger and increase in State trigger levels, at the depth of the recession from which we are now emerging a total of 34 States paid extended benefits (EB). This demonstrates the ability of the system to respond when needed.

To ensure that EB go to individuals with firm labor force attachment, current law requires that States limit EB payments to individuals with base period employment of at least 20 weeks of full-time work or the equivalent in wages.

Lastly, the OBRA-81 changed the method of calculating State insured unemployment rates by including in the count of insured unemployed only individuals filing regular claims for unemployment compensation (UI), and eliminating claimants for extended benefits. Including EB claimants artificially prolonged the EB period and resulted in inconsistencies in the definition of the term "high unemployment."

In making the computations to determine whether or not a State is triggered "on," only claims for regular UI benefits are counted. A State is required to reach the 5 percent trigger without counting EB claims. Before EB is triggered "on" there are, of course, no EB claims to count. If, after a State triggers "on," EB claims are counted in computations to determine an "off" trigger, this generally inflates the computation by about 18 to 20 percent. Thus a rate of 5 percent computed by including EB claims in the count is generally equivalent to 4.0 to 4.1 percent computed by counting only regular UI claims. Over the years, this has resulted in keeping States "on" EB at real rates of unemployment that would have resulted in "off" triggers if the same count of regular UI claims had been used for both "on" and "off" triggers. Removing EB claims from the computation also permits States which have paid EB in either of the 2 previous years to trigger "on" EB sooner if the economy declines. It was this change—the use of regular UI claims for both "on" and "off" trigger computations—that was included in the OBRA-81 amendments. The exclusion of EB claims from the trigger calculation had been proposed by regulation by the Carter Administration. It was struck down by a Federal Court, not on the merits of the issue, but because it represented a change from a long-standing prior interpretation. It was for this reason that the 1982 Carter Budget included legislation to exclude EB claims from the trigger calculation and that the identical proposal in the OBRA-81 legislation was initiated by the Reagan Administration.

These changes, overall, have provided equity and integrity to the extended benefit program.

Mr. Chairman, this completes my formal statement. We shall be glad to respond to your questions.

Senator ARMSTRONG. Senator Long, any questions for Ms. Golding?

Senator LONG. Maybe you can tell me where Louisiana stands in the unemployment situation now.

Ms. GOLDING. Yes, sir. I believe Louisiana is on extended benefits now. It's one of the seven States currently triggered on.

Senator LONG. What unemployment level do we have in Louisiana now? Do you have that?

Mr. VAN ERDEN. The State, right now, Mr. Long, has an insured unemployment rate of 5.61 percent. It's 165 percent above the average of the prior 2 years. The latest data we have on the total unemployment rate—the State of Louisiana for the month of May had an unemployment rate of 12.5-percent.

Senator LONG. 12.5; I'm not particularly happy about that. I'm not bragging about it. That is getting us up toward the Michigan situation, I regret to say. I've been voting for this program up to this point because I thought I was helping the other fellows—to help their States because of the national problem. But my own State is now one of the States that needs some help.

But all we are looking at in judging entitlement to benefits is the insured rate—5.6 percent—and not the 12.5 percent total rate. Is that right?

Ms. GOLDING. Right. It's the insured unemployment rate that we use.

Senator LONG. Now just as a matter of logic, what's the reason for going by the 5.6 rate rather than the 12.5 rate?

Ms. GOLDING. The logic is to maintain the tie to covered employment. The extended benefits program is financed by State and Federal employer taxes. They pay those taxes based on the number of employees in their employ. Thus, the insured unemployment rate deals with only covered employment, and those segments of employees in covered employment who become unemployed. The total unemployment rates reflects every one who is unemployed whether or not they have had prior work experience, whether they are new entrants to the labor force, reentrants to the labor force. It has no bearing on whether they have been previously employed by a taxpaying employer.

Senator LONG. So you are saying to me that we ought to measure unemployment by considering those who are unemployed who have been previously employed. Wouldn't it make sense to include all of those who have been employed and are out of work now?

Ms. GOLDING. I think the issue is whether those should be covered by a program that is financed primarily by employer taxes.

Senator ARMSTRONG. Senator Matsunaga.

Senator MATSUNAGA. Thank you, Mr. Chairman.

Of the 10 percent unemployed today, do you have any figures to show how many of those who are not on extended benefits are on welfare?

Ms. GOLDING. I don't have that.

Senator MATSUNAGA. Then of the 10 percent or so unemployed, how many today are on extended benefits?

Ms. GOLDING. While Mr. Van Erden is looking up that number, I think I might point out that when the total unemployment rate reached 10, the insured unemployment rate was 3.8 percent. So there was a significant difference.

Mr. VAN ERDEN. Senator Matsunaga, for the week of July 9, there were 188,000 individuals collecting extended benefits. I might add, at that same time, there were 903,000 collecting FSC, Federal supplemental compensation.

Senator MATSUNAGA. Nine hundred and three thousand?

Mr. VAN ERDEN. Yes. That's the third tier.

Senator MATSUNAGA. That's in addition to the 188,000?

Mr. VAN ERDEN. Yes, sir.

Senator MATSUNAGA. So that would leave a considerable number without any resource, assuming that they have no other resource. What would keep them from starvation?

Ms. GOLDING. In addition to those numbers that we gave you, another group of people would have been receiving the regular State unemployment insurance.

Mr. VAN ERDEN. There are 3.2 million individuals collecting regular unemployment benefits for that same week.

Senator MATSUNAGA. So you have 6.8 million without resources?.

Mr. VAN ERDEN. Roughly half of the individuals counted as unemployed by the Bureau of Labor Statistics would have been receiving benefits for that week.

Senator MATSUNAGA. Is there any proposal on the part of the administration to amend the existing laws so as to take care of the 6.8 million who have no resources whatsoever?

Ms. GOLDING. No, sir. There are no legislative proposals pending.

Senator ARMSTRONG. Senator Riegle.

Senator RIEGLE. Mr. Chairman, I appreciate your courtesy in inviting Senator Levin and I to come up and sit with you here.

How do you propose that we deal with the problem of this gap that is growing in the situation such as we have in Michigan where you have over a 10-percentage-point spread where you get this very high, persisting unemployment above 15 percent, and you get an insured unemployment rate of 4.75 percent? What does the Labor Department propose to do about that? I would think that troubles you just as much as it would trouble us. I would think that you would be thinking in terms of some way to deal with that. Certainly that would not be thought of in the normal range of circumstance, and it's something that would have been anticipated when the formulas were structured this way. This is an extraordinary problem. And it seems to me it requires some kind of special response. And I was waiting to hear what that was going to be when you were testifying, and I didn't hear anything.

And I say that because the President oftentimes will say things publicly to the extent that he is sympathetic with the problems of the unemployed, and yet very often when you come in, you don't bring anything. You don't bring anything that really addresses the problem other than just sort of justifications for the status quo.

And I'm just wondering how you propose to deal with this problem. We just can't let people starve to death out there.

Ms. GOLDING. I can't speak for the President and what he proposes in order to deal with the whole spectrum of problems. I can tell you that the rapid change and increase in the gap between the total unemployment rate and the insured unemployment rate is one that puzzles us. And it's a puzzle we have been trying to decipher for a while. It's a gap that has been growing since 1950. But the growth of the gap has been accelerated since the early seventies. And the pace has accelerated even more since 1980.

I think it would be appropriate to say that we have been monitoring the situation, and have a research contract to try to find out what is causing the gap in the hope that in identifying the cause of the gap we may be able to craft solutions more intelligently and that aim at solving the problem rather than perhaps blanketing in areas that we don't need to address.

Senator ARMSTRONG. My attention was distracted when you described the nature of the gap. Are you referring to the gap between the total unemployment rate and the insured unemployment rate?

Ms. GOLDING. Insured unemployment rate, yes.

Senator ARMSTRONG. All right.

Senator RIEGLE. Well, I want you to finish because then I want to ask you a question.

Ms. GOLDING. We have, as I say, let this research contract which we expect to complete by the end of the year. Looking at what we know so far, it appears to us that no single factor has caused the recent acceleration in this gap. Rather, it seems to be a combination of things. And I would cite maybe three or four examples. There have been a number of State and Federal law changes. We've had back-to-back recessions. We've had an enormous change in the composition of the labor force. All of these or any of these seem to have affected the relationship of the total unemployment rate to the insured unemployment rate.

And I think insofar as crafting programs—the point that I made before—the tie of the insured unemployment rate to coverage by employer taxes is a relationship that we would like to see maintained.

Senator RIEGLE. Well, let me just say very frankly that when you come you do come as a representative of the President. You are here speaking for the President. You are his agent on this subject before this hearing and to the country. And you are a bona fide expert on this problem. And you are the Director of the Unemployment Insurance Service in the Department of Labor. I mean that is a very major responsibility.

And it seems to me that if we have got a problem here, it may be well to make steady grants and so forth and to monitor the problem—and that's to use your words—but I think we've got to do more than that. I think you have got to come in with an affirmative response to the problem. And you have to speed up the analytical time here to try to figure out what is taking place.

I can tell you one thing. Part of what is taking place that I think is hidden in these numbers is the trade problems that the country is facing where we have got a trade deficit now that's approaching $70 billion a year in the merchandise account. And so a lot of the jobs that we had in this country that normally would come back in a cyclical, beginning of a cyclical recovery have moved offshore. They've gone to other countries.

But that doesn't do anything to help the person who is out there who is an unemployed worker and their family trying just to survive. And I would just say to you frankly I think you have an obligation to develop a recommendation; to go to the President to ask him for support for some kind of initiative to respond to this problem, and not just let the weeks and months go by. I mean just because all of us here in Washington are—you know, we are getting paid on a regular basis. The people out there that have run out of money, and are in desperate circumstances, and who, in fact, are not being reemployed need a response. And they need a response from this administration. And they need it now.

I think you have an obligation to come in with something, and not just talk around the problem. I don't mean it in a nonkind way. I mean it in a blunt way because that's what you are being paid to do—is find an answer. And I'm just wondering what you might have for us.

Ms. GOLDING. I think there is a basic issue here of how much of this problem we can expect the unemployment insurance system to bear at a time when States are struggling with solvency problems, just as the Federal Government is struggling with a solvency problem. This year, States will borrow nearly $7 billion. A third of the money that will be paid out in the extended benefits and the regular State UI programs. That's creating an enormous financial liability that will have to be paid out of employer taxes.

At the same time, if you craft other programs that are add-ons to the basic unemployment insurance programs, and you finance them from general revenues, you are building in another liability as well for Federal revenues. I think any solution that is going to be crafted has to walk a very fine line between fiscal responsibility and responsiveness to the needs of the people.

Senator RIEGLE. Well, I will just conclude. And I thank you, Mr. Chairman. I think you have an obligation for affirmative recommendations. You have an obligation to come in with an answer, and not just more illumination of the problem.

Senator ARMSTRONG. Carl.

Senator LEVIN. Thank you, Mr. Chairman.

Whatever the cause of the gap, it's a growing gap. The question is whether we are going to wait until January to find out what the cause of this is before we try to help people who are falling into that growing gap. I'm not on this committee. And I'm deeply indebted to the chairman and the members of the committee for allowing us to just ask a few questions as well as to testify. I would hope that we decide as a Senate that we just can't allow literally hundreds of thousands of people—over 400,000 people who have been negatively harmed by these changes—to simply sit in that position while we await a study which is due in January. I just don't think it's tolerable to do that.

I would hope that the agency can come in with some stop-gap measures to fill the gap, while we are studying the source of the gap.

Mr. Chairman, just a couple of questions.

You have indicated the reason for not using the total unemployment rate is because you would thereby be considering people who are not part of a program financed by employer taxes. Is it not true, though, that people who have exhausted their benefits were part of a program that was financed by employer taxes?

Ms. GOLDING. It's true that exhaustees who have been regular UI beneficiaries and who have been EB claimants have been part of covered employment.

Senator LEVIN. But even those folks were part of the program that was financed by taxes, you don't count them. So on the one hand you say you don't want to look at the total rates because that would include people who are not part of an employer financed tax system, and on the other hand you are saying you don't want to count exhaustees either even though they were part of such a system. I think there is an inconsistency in that.

At the minimum, if you are going to use the logic for not using the total unemployment rate that you would be thereby including people who were not part of the program financed by employer taxes, that logic ought to drive you, it would seem to me, toward including people who were exhaustees.

And one other question on it. If you had a good statistic sample for the total unemployment rate in all 50 States or in all the jurisdictions—there are more than 50, I guess—would you be willing to use the total unemployment rate? Recommend that we use that? Or is it the lack of a statistical sample which forces you away from using the TUR?

Ms. GOLDING. Let me take the second one first. The total unemployment rate, as you point out, is done on a sample basis. The insured unemployed rate is not done on a sample basis. It's done on a universal count basis. For every statistic that the program reflects in the insured unemployment rate, there is a claimant in place. No matter what the confidence level for any sample, the universal count would be more reliable, and we would prefer to stay with the insured unemployment rate.

To go back to your first comment, when we calculate the insured unemployment rate for purposes of triggering on extended benefits, we count the exhaustees of regular State UI programs. If you then include the exhaustees of extended benefits in the count of insured unemployment for purposes of triggering off, you are inflating the count of the insured unemployment rate. And you are introducing about an 18-to-20 percent inflation rate in that. That means that you are triggering on with one statistical count, and triggering off on a totally new basis.

At some point, you could argue that that works in a State's favor. But you can argue also that that artificially prolongs an extended benefit period. It works to the State's detriment once they have been on EB, when they come to the point where their economy is declining. They have to hit a higher threshold in order to trigger back on if extended benefits claims have been included in the count.

Senator LEVIN. We hear from the representative. The committee will state relative to that issue. I finally got an answer to Senator Long's question. I'm sorry I didn't have this handier. Louisiana is No. 5 in May. It was No. 6 in April.

But let me emphasize again what is going to happen next month, we understand. Louisiana with a 12½-percent unemployment rate is going to trigger off this program. That is going to join those of us with high unemployment rates who are going to trigger off while other States with lower unemployment rates are going to be on it. And I would hope that the Department of Labor—you are shaking your head. Is that not true? That it's likely to trigger off?

Mr. VAN ERDEN. Senator, I just was pointing out that as I understand your bill, for a State like Louisiana to trigger on extended benefits it would have to average 11 percent for the last 12 months and be over 11 percent in the last month. Louisiana's last 12-month average was 10.23 percent. So even under your bill it wouldn't qualify.

Senator LEVIN. Well, we calculated that they would be eligible for three of the four quarters of 1984.

Mr. VAN ERDEN. Yes. I'm just saying current data——

Senator LEVIN. They would become eligible after one quarter, and then would be eligible for three-fourths of the year.

If nothing else, I would hope that the Department of Labor would agree that it doesn't make any sense in a State such as Michigan, whose unemployment rate went up from May to June, to have its extended program lost to it, and to have its employment benefits reduced from 53 to 36 weeks. If nothing else, I would hope we could agree on that. That when you have an actual unemployment rate, which means how hard is it to get a job, going up 14.9 to 15.2 percent, to have a number of weeks of benefits reduced from 53 to 36 weeks makes no sense. I hope we can agree on that.

Mr. VAN ERDEN. We probably should point out that the total unemployment rate was increasing during that period, but the insured unemployment rate, for a number of reasons, was dropping dramatically.

Senator LEVIN. I did point that out. Insured unemployment rate has nothing to do with how hard it is to get a job. How hard it is to get a job is how many people you have got looking for work.

Mr. Chairman, I have taken more time than I should have. I thank the committee.

Senator ARMSTRONG. Thank you. That's a very useful exchange.

Senator LONG. I'd like to ask a question.

Senator ARMSTRONG. Of course, go right ahead.

Senator LONG. Is Louisiana going to trigger off? [Laughter.]

Senator ARMSTRONG. Tune in next week.

Mr. VAN ERDEN. Mr. Long, right now Louisiana would have to drop to either 5 percent of insured unemployment, and they are now at 5.6, or their 120-percent factor would have to fall from 165 to 119 percent. It's unlikely they would trigger off in the near future.

Now let me qualify that. The rates that we use are not seasonally adjusted. And that means that every year at this time, during the months of August, September, and October, we reach the low point of the year. It's likely or possible that sometime between now and the end of, say, September or October, Louisiana could go below 5 percent. It's unlikely they would go down within the next month.

It is also likely that they will come back up again in the fall as seasonal unemployment increases, and will trigger it back on.

Senator LONG. Well, I would prefer, of course, not to be on the program provided that we don't have the level of unemployment that would cause us to be on there. I don't want to be on there. But it does concern me that we have this 12½-percent unemployment.

Could you furnish me for the record with your analysis of just how this breaks down as to who are these people who are not receiving unemployment benefits. If you could provide that, I would like to have it.

Mr. VAN ERDEN. Certainly.

Senator LONG. Thank you.

[The information from Mr. Van Erden follows:]

The Bureau of Labor Statistics (BLS) reports that Louisiana had an average of 192,000 people unemployed in calendar year 1982. Of the 192,000, 52.9 percent were job losers, 9.5 percent job leavers, 25.6 percent reentrants and 11.9 percent new entrants. Of the 192,000, 56.8 percent were men and 43.2 percent were women. During this same period of time, the average weekly number of individuals drawing regular UI was 67,000 with an additional 4,700 on extended benefits, 10,000 on Federal Supplemental Compensation: a total of 8,700. This represents 42.6 percent of those counted as unemployed in the BLS data. A crossmatch between the two sets is not possible; however, the job losers would in all likelihood be those most likely to be eligible for UI benefits.

Senator ARMSTRONG. We are going to try to move fairly quickly because we have a lengthy agenda of witnesses. But I do have two questions that I want to address to our witnesses.

First, Ms. Golding, at the outset you made the point that the question was—I don't mean to put words in your mouth, but as I understood it—but the question was not whether or not the Federal Government or the State government might have a responsibility to help people in need, but the extent to which this ought to be borne under the unemployment compensation system, by the payroll tax, and by the employers and employees who pay into that.

In that regard, I just want to be sure that I understand correctly that under any of the proposals which are pending, one that Senator Levin has introduced and others that may be floating around, but at some point there is a cliff. At some point somebody could be out of work, even large numbers of people might be out of work. And at some point or another, the benefits run out. So what we are really talking about is when that ought to occur, not if it ought to occur.

Ms. GOLDING. That's correct.

Senator ARMSTRONG. Are you aware of any legislation which has been introduced which would not have in effect a notch or a cliff or whatever you want to call it?

Ms. GOLDING. I'm not aware of any such proposal.

Senator ARMSTRONG. Can you conceive of any? Can you think of a way to avoid that other than just putting people on a lifetime unemployment system?

Ms. GOLDING. No.

Senator ARMSTRONG. Are you familiar with the system that they use in Italy?

Ms. GOLDING. No.

Senator ARMSTRONG. Well, in Italy they have what amounts to, I am told, a lifetime system. Once you get a job and get into the system that you can stay unemployed basically forever; and draw rather handsome benefits.

I just make that point, not to argue, at this stage of the game I would say to my colleagues but only to note that the real issue should not be framed as whether or not we care about the people who are unemployed, but the question is whether or not, as Ms. Golding said at the outset, the extent to which the cost of caring for them should be borne through the unemployment compensation system.

I also want to turn to another question, if I may. Since 1977, the Nation's employers have been subject to a 0.2-percent tax dedicated to the repayment of extended benefits debt to the general treasury. This debt now totals, I am told, $6.8 billion. The tax would be in place until the debt is repaid. Under the current law, when would you estimate that that debt would be repaid?

Ms. GOLDING. Under current law, we would expect that debt to be repaid by the end of fiscal year 1987. And that would mean that effective January 1, 1988, we would eliminate that extra 0.2 percent tax.

Senator ARMSTRONG. Taking into account the best information now available with respect to the state of the economy and who triggers on and who triggers off and so on?

Ms. GOLDING. Yes, sir. That would be based on the midsession estimates.

Senator ARMSTRONG. If we made changes in the program which caused more states to trigger on, I guess it goes without saying that the ultimate repayment date would be pushed back.

Ms. GOLDING. Yes, sir, it would.

Senator ARMSTRONG. Thank you very much. We appreciate your coming.

Senator MATSUNAGA. May I make one request?

Senator ARMSTRONG. Yes, of course.

Senator **Matsunaga**. At present, as I understand it, there are about 180,000 unemployment persons on extended benefits, and Senator Levin's bill will add an additional 280,000, which would bring the total up to 460,000. Now this is a very small percentage of the total unemployed. I would like to know how many of the 11 million or so unemployed are receiving unemployment compensation and extended benefits as well as welfare benefits. Also how many of the unemployed have no source of income at all.

I ask this question because as Senator Riegle himself expressed and I expressed earlier—we would like to know what the administration has in mind for those who are without resources. Despite the fact that we talk about economic recovery to these millions of Americans, economic recovery means nothing if they continue to be without food and without shelter.

I think this is an important matter that needs to be addressed. And I, for one, would like to know what the administration has in mind.

Ms. **Golding**. Well, as to the information you have requested, we will supply it for the record.

Senator **Armstrong**. Thank you very much.

[The information from Ms. Golding follows:]

As of July 1983, the latest month for which information is available, there were 10.7 million individuals counted as unemployed in the CPS. Of these, 4.18 million, or 39.05 percent, were receiving UI. Of the 4.18 million, 3.2 million were receiving regular UI; .12 million, extended benefits; and .85, Federal Supplemental Compensation. The UI systm does not collect information on those receiving other types of income supplements simultaneously with UI payments.

Senator **Armstrong**. Senator Mastin, come forward. I was intrigued by the compliments paid to you by Senator Riegle. Out our way we are always a little cautious about complimenting State legislators for fear they may have ideas of running for the U.S. Senate or something.

Senator **Levin**. Mr. Chairman, before you get a response, I want to give him time to figure that one out.

If I could, just for the record, let me indicate that our figures regarding Louisiana triggering off in the first quarter of fiscal year 1984 comes from the CBO. That's the source of that. And if I just could, Mr. Chairman, take the liberty of one quick comment.

And that is that there is a lot of general fund money that is going into this system as well as insurance that is paid by employers. A question of who you allocate general fund money. Which States are the beneficiaries and what are the formulas, and how we are doing this recession compared to the last recession. I think those are additional questions that I hope you will address as well as the one which I think you will begin with.

Senator **Armstrong**. Thanks. Good point.

STATEMENT OF HON. PHILIP O. MASTIN, CHAIRMAN, LABOR COMMITTEE, MICHIGAN STATE SENATE, LANSING, MICH.

Senator **Armstrong**. Well, Senator Mastin, thanks for coming. From your introduction, it's obvious you are an authority on this subject, and we are eager to hear from you.

Senator **Mastin**. Thank you very much, Mr. Chairman and members of the committee. And I do appreciate the introduction by Senator Riegle. And just for the record, it ought to be very clear that I have no intention of doing anything but supporting Senator Riegle. He is a good friend, as is Senator Levin.

I sincerely appreciate the opportunity that you provided for the Michigan Legislature, in effect, to be represented through myself as chairman of the senate labor committee. Prior to service in the Michigan Senate, I was a member of the Michigan House of Representatives for a period of 4 years, serving on the labor committee for that body.

I don't want to be redundant in my testimony. You've heard a great deal about the situation in Michigan. There are some comments, though, that I would like to make and perhaps some points that could be brought out during questioning, if that is your wish.

You've heard the story about Michigan's economic situation. I thought that perhaps rather than going into the large picture, I could by just illustration by one example in one community—a community that I represent, Pontiac, Mich., which houses five General Motors divisions. General Motors is our big employer. It's an automobile town. It's world headquarters for two of those divisions. Pontiac Motor Division, for years, has been one of the major employers in the city of Pontiac.

As you know, General Motors along with other automobile manufacturers, have had to go to the new kind of automobile plant, the so-called zero-inventory plant. It's highly automated. High use of robotics. They recently built a plant of that nature just outside of the Pontiac city limits.

They intend to move their operation there effective the beginning of this coming year. The Pontiac Motor Division employed a little over 14,000 Pontiac area residents, and has done so historically. The new plant, the Orien plant, working two shifts, will employ 6,000 people. And it's the 8,000 people who are falling through the cracks, as it were, that we are most seriously concerned about. Those others, thanks to Federal programs——

Senator MATSUNAGA. If I may, with the same production?

Senator MASTIN. Yes.

Senator MATSUNAGA. Same production?

Senator MASTIN. They anticipate that they will be able to produce the same volume of automobiles, but to do it with a work force of approximately 40 percent of what they had previously employed. That's going to be the pattern, by the way, in the automobile business regardless of where the plants are located, whether they are in Missouri or California or Michigan. And they are all building them that way.

And so we see in Michigan a series of problems developing. One, the issue that I am here to testify on today, has been caused essentially because in Michigan we have experienced not only very high unemployment—the Pontiac area that I represent has been in the 30 percent unemployment range for the past several years. It's an unbelievable problem.

But what is occurring there is that not only do we have the high unemployment, but we've had it for such a terribly long period of time. The people have exhausted their 26-week basic benefit, which is paid by the State trust fund through the employers. They've exhausted their supplemental benefits. They've exhausted their extended benefits, which is a 50-50 match between the State and the Federal unemployment insurance funds.

And the chairman made a comment a little bit ago about the falling off the cliff. Well, a lot of Michigan people are falling off that cliff. And I want you to know what happens when that occurs.

Essentially, people receive no benefits until they can qualify for some sort of public assistance. You can't qualify for that until you've eaten up your assets. So what essentially happens is people tend to go on public assistance within 2 to 4 to 6 months after they have exhausted their benefits.

I'm not familiar with the system. Does that red light tell me to get back on my testimony or just quiet down?

Senator ARMSTRONG. It tells you in theory that you are done, but we know you have come a distance, and so we do have a lengthy schedule, and we would like to keep reasonably on time, but go ahead and complete your thoughts.

Senator MASTIN. Thank you for that courtesy. I do appreciate it. And I will try to be brief.

The new trigger that has been suggested in the legislation introduced by Senator Levin or some variation of that is very, very badly needed in our State. We've lost—56,000 families in our State have lost the extended benefits, and the supplemental benefit has been lost by an additional 10,000 families. This is being repeated, as I think Senator Levin indicated, in other States. Ohio, I believe, is a very, very similar example. And the numbers are almost identical.

These people need some relief. And the options really, I think, as a personal, public policy is do we maintain people as long as we can on some income maintenance program such as extended benefits, which are paid jointly by State and Federal trust funds; or do we make these people, in essence, at an accelerated rate charges of the public in another way through 50-50 matching on aid to families of dependent children of the unemployed.

I can give you just one example. A family of four in Michigan on ADCU receives $556 per month. And that is shared 50-50 between the State and Federal Governments out of our general fund.

The maximum unemployment insurance benefit for a family of four would be $788 a month shared 50-50 between our respective trust funds.

And the major difference, it seems to me, is in terms of the future of these many families and is simply this. That in order to maintain their extended benefits privilege they need not divest themselves of assets that they have carefully built up as a family unit over many, many years. But in order to go on public assistance, of course, they must. That is the tragedy that is occurring to tens of thousands of families in Michigan. We are literally adding 5,000 families a month to our social welfare roll. And it seems to me as it does, I believe—it was Senator Levin's remark. It is simply logic that in a State where the gap is growing between the insured unemployed and the big number, that gap is just growing at an astronomical rate, far beyond what it is nationally—but some relief for these exceptional situations, States that have experienced long-term unemployment should be considered very, very seriously by the Federal Congress.

And we are appealing to you from our State—please give us as much relief as you can. I know the situation is tough up here too, but it's very, very difficult in Michigan.

Thank you.

Senator ARMSTRONG. Senator, thank you for a very thoughtful and moving statement.

[The prepared statement of Senator Mastin of the Michigan State Senate Labor Committee follows:]

TESTIMONY BY SENATOR PHILIP O. MASTIN, CHAIRMAN, MICHIGAN SENATE LABOR COMMITTEE

Mr. Chairman, members of the committee, I am Senator Philip O. Mastin and I am the Chairman of the Michigan Senate Labor Committee. I would like to express my appreciation for the opportunity to present my concerns about the problems facing the long-term unemployed in Michigan.

In order to evaluate the significance of the issues that will be addressed by this Subcommittee on Michigan, I believe it is essential that you understand Michigan's current economic situation.

The distressed automobile industry and the resulting impact on Michigan have received national attention, but I do not believe that the nation realizes the severity of the unemployment depression that encompasses the state of Michigan. The Michigan unemployment rate was 14.6 percent in June 1983 and has been in double digits for every month since 1980. In that forty-two month period, Michigan has had the highest state rate of unemployment in all but ten (10) of those months.

The auto industry has always been sensitive to the cycles of the national economy. Consequently, Michigan expects the recession/recovery cycle, where unemployment climbs sharply for a period of time and then is followed by a vigorous recovery. However, the events which began with the energy crisis of the mid-seventies and which were exacerbated by: higher interest rates, foreign competition, and the lack of consumer demand have had a prolonged, and permanent, effect on the auto industry. In 1982, motor vehicle production was the lowest in 20 years and more than 40 percent below the output levels of 1978.

After three consecutive years of severe recissionary conditions, the state has lost four hundred thousand jobs. Because of the pervasive nature of the unemployment depression in Michigan, nearly every resident and business has been affected. In 1982, the number of jobless averaged 660,000. These levels of unemployment mean that in Michigan's labor force nearly one of every six is unemployed. Manufacturing employment has declined by almost one-fourth and construction by almost 40 percent between 1979 and 1982.

The job loss has dislocated many workers in all areas of the state. In May 1983, over 40 percent of the unemployed workers are of prime working age 25–44 and nearly two-thirds are male. The employment situation of females and minorities has seriously worsened. For May 1983, the female unemployment rate was 13.3 percent, the black unemployment rate was 30.1 percent and the unemployment rate of black youth was a staggering 47.6 percent. Major areas within the state have also been subject to the severe impact of the recession. Michigan's Upper Peninsula had an unemployment rate of 18.2 percent. The second highest unemployment rate was in the Muskegon area with 17.7 percent.

Since the late 1930's, the initial level of protection for people who lost their jobs in this country has been the Unemployment Insurance (UI) program. Because of the highly cyclical nature of Michigan's economy, it has played a critical role in maintaining some stability in the state's work force.

The purpose of the Extended Benefit (EB) program has been to provide benefits to individuals who have had an extended duration of unemployment, and who have exhausted their rights to regular state benefits, during periods of high state unemployment.

The EB law passed by Congress included a triggering mechanism called the Insured Unemployment Rate (IUR). When such rate reached a certain level (originally 4.0 percent), and 20 percent higher than the average of the comparable period for the prior 2 years, then the EB program would trigger "on". (The criteria for triggering "on" currently is 5.0 percent and 20 percent higher.) This triggering mechanism was intended to insure that EB would trigger "on" only when unemployment went up to a certain level and only when such unemployment was rising above the prior year's levels.

This, however, presented a problem in states which had high rates of unemployment for an extended period of time but such unemployment was not 20 percent greater than the average of the comparable 2 years which was also high. Failing to meet the 20 percent requirement resulted in failure to meet the trigger requirement for an EB program in such state.

In response to this situation, federal law was amended to permit the states the option to trigger "on" without regard to the 20% requirement as long as the state's IUR reached a level higher than the original 4.0 percent (originally set by Congress at 5 percent but increased to its current 6 percent).

Such change, however, has not solved the problem that the IUR rates do not appear to properly respond during long periods of high unemployment. The problem exists because of the method used in calculating the IUR. In determining the IUR, only individuals receiving state regular benefits are counted; not counted are the unemployed who are drawing benefits under some other program, such as FSC or EB (EB claimants were originally counted), nor are those counted who have exhausted unemployment benefits under all available programs and are still unemployed. In addition, in response to federal law changes, states have amended their law to make qualifying for state benefits more difficult; preventing such individuals from qualifying for state benefits has removed another group from the unemployed used to determine the IUR.

The problem can be best seen by comparing the IUR in a state (which may be declining) with a Total Unemployment Rate (TUR) in that state. Attached Table I shows that although Michigan's TUR is currently 14.6 percent, the IUR has dropped to 4.61 percent, and that the disparity between the TUR and IUR has increased greatly, both in Michigan and nationally. Certainly, there must be something wrong with a program, which was intended to benefit the long term unemployed during periods of high unemployment, but which triggers off in Michigan which has a TUR of 14.6 percent and has had double digit unemployment rates for 3 years.

Because of this situation, I strongly urge Congress to review the EB trigger requirements toward the end that a responsive state EB trigger be adopted, or that an exception to the current EB requirements be made for states with high (and continuing) unemployment.

I would also like to take this opportunity to recommend that Congress extend, beyond September 30, 1983, the Federal Supplemental Compensation (FSC) program. If nothing else, such extension would be a short term solution for individuals who exhaust regular state benefits without EB.

In addition, I would recommend that the FSC program be made simpler. Rather than the current maximum of 8, 10, 12, 14 or 16 weeks of benefits, dependent on IUR's of "above 6 percent", "less than 6 percent but at least 5 percent", "less than 5 percent but at least 4 percent" and "below 4 percent", I would recommend that 8 weeks of FSC be made available in all states when the national IUR is at least 4 percent but below 4.5 percent, and 16 weeks of FSC when the national IUR is 4.5 percent or above.

Lastly, I would recommend that when FSC triggers "on", it interrupt EB payments in those states that are on EB and pay EB after FSC is exhausted. As currently structured, states with high unemployment who are paying EB must finance 50 percent of such benefits while states which are in better shape, and are not paying EB, are paying FSC which is 100 percent federally financed.

TABLE I

Calendar year	TUR	IUR	Difference
National:			
1978	6.1	2.8	3.3
1979	5.8	2.8	3.0
1980	7.1	3.8	3.3
1981	7.6	3.5	4.1
1982	9.7	4.7	5.0
Michigan:			
1978	6.9	3.8	3.1
1979	7.8	4.7	3.1
1980	12.4	8.8	3.6
1981	12.3	6.0	6.3
1982	15.5	7.6	7.9
1983	[1] 14.6	[2] 4.6	10.0

[1] June 1983.

[2] July 2, 1983, 13-week moving average.

Senator ARMSTRONG. Senator Long.

Senator LONG. Thank you very much.

Senator ARMSTRONG. Senator Matsunaga.

Senator MATSUNAGA. One question. Earlier the chairman talked about the economic system in Italy. In Japan they have the so-called Kaisha system where once you are employed by the company, the company takes care of you for life. Not the Government, but the company. And I was wondering what, if any, effort has been made by the workers themselves or the employers to install such a system. I suppose it would become even more important if a machine stole the place of a human being.

Senator MASTIN. Senator, I believe that I've studied the difference between our system and the system in Japan a little bit. I don't claim to be expert.

One of the things that impresses me about the difference between the two systems is that traditionally we've placed great value on allowing business and labor to sit down and sort of work things out. Sometimes that is done wisely and well. Most of the times, I suppose it is. But often it is not.

What I like, what I see in the Japanese system that I personally value and appreciate is the fact that Government has become a partner in those discussions, in those deliberations. That, I believe, is probably where we should be going in this country in our respective States. We've not done that. It is going to be a little bit of a hurdle to get over just as I believe it is going to be a hurdle for the Federal Department of Labor to try to adjust to the changing situation. This 6 percent, nobody thought that that would be broken, I am sure, when legislation was adopted just a few years ago.

We need more of a partnership between Government and business.

Senator MATSUNAGA. I'm inclined to agree.

Senator ARMSTRONG. Well, Senator, thanks for coming. If you will leave your address behind, I would like to send you a very interesting essay by the eminent historian Paul Johnson that discusses the alleged partnership between business and Government in Japan. And I think after you read that you might be at least a little less enamored of it. And I'm going to send you a copy of that too, Spark.

Senator MASTIN. I will look forward to that, Mr. Chairman.

Senator ARMSTRONG. Really, leave your card. I would like to send it to you because it debunks a lot of myths that have grown up.

Also I want to encourage you both to read an extraordinarily interesting new book by a professor from the University of Maryland by the name of Manser Olsen called the "Rise and Decline of Nations," which also focuses on the popular misconception in part—that's not the whole subject of the book—on the popular misconception that Japan has prospered because of this great partnership. Obviously, today is not the day to debate that issue, but I would at least encourage you to take another look.

Thanks again for coming.

Senator MASTIN. Thank you.

Senator MATSUNAGA. Mr. Chairman, while we are worried about our 10-percent unemployment rate, the Japanese are worried because theirs is approaching 2 percent.

Senator ARMSTRONG. I guess I should know better than to wander off into these thickets. [Laughter.]

Senator MATSUNAGA. I thought I would have the last word, Mr. Chairman.

Senator ARMSTRONG. You still can have the last word. My observation is that, first, the Japanese are a wonderful success story. But the notion that the reason for their great success is because of this close working relationship between Government and business has been overemphasized. That their success arises from some other factors—the excellence of their education system, the enormously high savings rate of Japanese people and some other factors. And, second, I would have to say that as much as I admire the Japanese, it appears to me that their economy is slowing down, and they are about to have the same kind of problems that we are having here. I hope not.

Thank you, Senator.

Senator MASTIN. Thank you. I will look forward to that.

Senator ARMSTRONG. If you will leave me your address, I will send you that article.

Now we are very pleased to have a further discussion of this matter by a panel consisting of Mr. Stanely L. King, Chairman of the Council on Unemployment Compensation of the U.S. Chamber of Commerce, and I believe he is accompanied by a legal counsel, Mr. Eric Oxfeld; also Cheryl Templeman, staff associate, Unemployment Insurance, Interstate Conference on Employment Security Agencies; and by Mr. Bert Siedman, director, of the Social Security Department of the AFL-CIO.

My thanks to you all for coming. My apologies for running a little behind schedule. But we are very pleased to have you, and are looking forward to your testimonies.

May I begin with Mr. King.

STATEMENT OF STANLEY L. KING, CHAIRMAN, COUNSEL ON UNEMPLOYMENT COMPENSATION, U.S. CHAMBER OF COMMERCE, WASHINGTON, D.C.

Mr. KING. Thank you, Senator. I'm delighted to be here.

Senator ARMSTRONG. Would you speak right into the microphone and we will see if it is working.

Mr. KING. How's that?

Senator ARMSTRONG. I don't think it's working. We wouldn't have that problem in an economy where there was a closer working relationship between Government and the private sector. [Laughter.]

Mr. KING. Thank you very much. It's a pleasure to be here. And I appreciate the opportunity to present the views of the chamber on unemployment compensation extended benefits.

As the Senator before me said, he didn't want to be redundant, and neither do I. It seems to me that a number of very competent people have set forth in fairly understandable terms, I think, how the plan works, and what some of the areas of concern are.

I guess I would agree with Carolyn Golding pretty generally in the notion that we think the system was reformed importantly several years ago, and those reforms were justified, I think, by sound policy, and they ought to be retained.

But one of the things I think I would like to say is that sometimes I think we forget that we have a three tier system here with a couple of cliffs, Senator. We have a regular State program of unemployment benefits, which generally run for 26 weeks in most States, fully funded by employers in that State.

Then we have the extended benefits program, which we have been talking about here, which is a partnership program between the States and the Federal Government, with the employers funding half of that.

And, finally, we move on into further extended benefits, which are funded out of general revenues.

And the real question here, I think, is one that we have been discussing. Namely, what is the unemployment insurance program intended to do? What is a State program intended to do? And a State program is intended to provide income maintenance for those people who are temporarily out of work through no fault of their own. Sometimes that lasts longer than the 26 weeks, and we have entered into a partnership with the Federal Government.

If it goes beyond that point, the policy in this country today is that it is no longer solely the responsibility of the employer to pay for the benefits in that extended period. This in no way reflects on the attitude that employers have about the problem in this country, and the need to find ways to solve it.

But I do believe that the solving of that problem should not rest solely in the hands of the employers.

I'd like also to say that we have had a very touching appeal here for help from the Federal Government to the State of Michigan and other States. And that there is nothing in the law that precludes any State from going beyond its present program for unemployment benefits without the help of the Federal Government. The State might look to some ways in which it could find additional benefits for its employees who are unemployed. And whether or not the employers in that State should participate or not in that or to what degree is solely dependent upon what the legislators in that State and the businesses and the other citizens of that State decide they want to do.

I'm not suggesting that program for chamber of commerce or for myself, but it just occurred to me when someone was saying, well, why don't we find other ways. I suggest that is one that I don't think I have heard of.

I think that if anything is necessary in the present EB program there might be some additional fine tuning, but I don't think I will take any time to go into that at this point. And in trying to keep with the schedule, I think I will stop at that point.

Senator ARMSTRONG. Thank you very much. I note that you have submitted a statement in writing.

Mr. KING. Yes.

Senator ARMSTRONG. And we are very happy to have that as well. And we appreciate your participation on that of the chamber.

Mr. KING. Thank you.

[The prepared statement of Mr. King follows:]

STATEMENT
on
UNEMPLOYMENT COMPENSATION EXTENDED BENEFITS
before the
SUBCOMMITTEE ON SOCIAL SECURITY
AND INCOME MAINTENANCE PROGRAMS
of the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Stanley L. King
August 1, 1983

My name is Stanley L. King. I am Vice President -- Personnel for Central Services Organization, and Chairman of the U.S. Chamber's Council on Unemployment Compensation. I also am a member of the Federal Advisory Council on Unemployment Insurance. I am accompanied by Eric J. Oxfeld, the Chamber's Employee Benefits Attorney and staff executive for the Chamber's Council on Unemployment Compensation.

We appreciate the opportunity to appear on behalf of the Chamber to present our views on the unemployment compensation (UC) extended benefits (EB) program.

The U.S. Chamber strongly supports a sound UC program for workers who are temporarily and involuntarily unemployed. During periods of high and rising unemployment, it is appropriate for states to extend the maximum duration of benefits because it may take longer than normal for UC claimants to find work.

That need is fulfilled by the EB program, which is an automatic benefit extension required by the Federal-State Extended Unemployment Compensation Act. As a result of recent amendments to that Act, the present program is a sound one. The changes accomplished by those amendments were important reforms and should be retained. Additional fine tuning of EB, however, would be desirable to help claimants find new jobs, disqualify claimants out of work because of a labor dispute, and require states with stable unemployment rates to trigger off EB. Conversely, Congress should refrain from unwise proposals to change the triggering and financing mechanism for EB.

The Extended Benefits Program

Federal law requires states to pay up to 13 additional weeks of UC benefits to claimants who have exhausted their "regular" benefits of up to 26 weeks. Payment of EB in accordance with federal dictates is a conformity requirement, whose violation would deny employers the standard tax credit under the Federal Unemployment Tax Act (FUTA) for operating in a state with an approved UC program.

A state must pay EB during certain periods. An EB period begins whenever the statewide insured unemployment rate (IUR) reaches a statutory level or "trigger" and continues while the statewide IUR equals or exceeds the trigger rate. However, an EB period lasts a minimum of 13 weeks, and a state that has triggered off EB may not trigger back on for 13 weeks. The IUR is derived by dividing the number of claims for regular benefits into the number of workers covered by unemployment insurance.

There is a standard trigger and an optional trigger. States must pay EB when the statewide IUR is 5.0% or more and has increased 20% relative to the average rates for the corresponding 13-week periods in the preceding two years. States may pay EB when the statewide IUR is 6.0% or higher. All but 13 states use the optional trigger.

Federal law requires that benefits and eligibility criteria for EB be the same as applied to the last week of regular benefits, except that states may not pay EB to any claimant who has worked less than 20 weeks or the equivalent during the qualifying period.

Unlike regular benefits, which are financed wholly by state unemployment tax revenues, EB is financed in equal measure from state unemployment taxes and FUTA revenues. At present the federal share of EB is financed by .32% of the standard FUTA rate of .8%, of which .2% is a temporary surtax.

The federal share of EB is credited to the Extended Unemployment Compensation Account (EUCA) in the Unemployment Trust Fund. The U.S. Labor Department (DOL) projects that EUCA will be in deficit by $6.8 billion at the end of fiscal year 1983 (April 26, 1983, UI Outlook). Of that amount, however, only $1.0 billion is attributable to EB; the remainder is the legacy of the Federal Supplemental Benefits program (a temporary extension of benefit duration for EB exhaustees during the late 1970's). DOL forecasts that the EB debt will be repaid in full in FY 1984, and the entire EUCA debt will be repaid in FY 1986. Repayment has been accelerated by a 1982 FUTA increase, which was allocated entirely to EUCA until the debt is repaid. The .2% FUTA surtax will expire when the EUCA debt is repaid.

History of Extended Benefits Program

The permanent EB program established in 1970 was the product of dissatisfaction with previous temporary benefit extensions that were criticized for getting under way too late. Although Congress lowered the EB trigger rates on several occasions in the early 1970's, the program was essentially unchanged until a series of amendments beginning in 1980.

Amendments enacted in 1980 ended eligibility for interstate EB claims unless both the agent state and the payor state are in EB periods. A separate enactment that year also withheld the federal share of the first week of EB in states that do not require a non-reimbursable waiting week for regular benefits. And it required states to disqualify EB claimants who are fired for misconduct, fail to seek suitable work, or refuse an offer of suitable work; "suitable work" is defined as any job that pays at least the minimum wage or the claimant's weekly benefit amount, whichever is higher.

The 1981 amendments eliminated the use of a national trigger of 4.5% nationwide IUR, raised the state triggers by 1%, stopped counting EB claims in calculating the IUR, and limited eligibility for EB to individuals who had worked at least 20 weeks or the equivalent. In 1983, the EB statute was amended to allow states to pay EB to claimants who are unavailable for work because they are hospitalized or on jury duty.

EB Amendments Were Needed Reforms

With few exceptions, these amendments have been needed reforms that targeted the extensions on individuals and states that need them most. The rationale for these changes is briefly reviewed, as follows:

1. Eliminate the national trigger. The national trigger required all states to extend benefit duration whenever the national unemployment rate reached the trigger level. However, state unemployment rates vary widely, even during major economic downturns. Consequently, when the national trigger was on, duration was extended in states where economic circumstances did not justify such an extension. In fact, because the average claim duration is known to increase with increases in the maximum duration, the national trigger discouraged workers in states with a tight labor market from accepting jobs.

2. Raise the state trigger to 5.0% and 6.0%. Duration should be extended only when economic conditions warrant the additional expenditure. The 4.0% and 5.0% triggers, in light of the current composition of the workforce, simply did not represent a level of unemployment justifying the EB extension.

3. Require 20 weeks of work or the equivalent to qualify for EB. UC benefits are intended only for individuals with a strong attachment to the workforce. It is appropriate, therefore, that an individual entitled to 39 weeks of combined regular benefits and EB should have worked at least 20 weeks before layoff.

4. Disqualify claimants who fail to accept minimum wage jobs. While one purpose of UC is to allow an individual who loses a job a period of time to search for suitable work rather than accept the first job offer, society is not obligated to allow search for a similar job to continue indefinitely. As the duration of an individual's claim lengthens, it is appropriate to narrow the range of choices. Several states, for example, require claimants to accept jobs paying less than their pre-layoff earnings after drawing benefits for an initial period. Once a claimant has been out of work for as long as 6 months, a job paying at least the minimum wage or the amount of the claimant's benefits should be considered "suitable."

5. Disqualify a claimant who is fired for misconduct or leaves work voluntarily. UC benefits should be paid only to individuals who lose their job through no fault of their own. They should not be paid to

individuals who leave work voluntarily or are fired for misconduct. It is appropriate for federal law to deny EB to such claimants.

6. Withhold the federal share of the first week of EB from states that do not have a noncompensable waiting period. In recognition that the costs of UC are nearly entirely paid by employers, and that for many individuals the duration of unemployment is brief, it is appropriate for states to pay benefits beginning in the second week of unemployment. Some states do not use a waiting week, however, and some other states, that do use one, pay benefits retroactively when the duration of a claim exceeds a prescribed number of weeks. While we oppose a federal standard requiring a noncompensable waiting week, because we are opposed to federal standards governing the regular UC program, we support requiring claimants to serve a noncompensable waiting week as an eligibility condition for receipt of EB.

7. Count only regular claims in calculating the insured unemployment rate. The practice of counting claims for regular benefits and EB resulted in an inflated IUR that caused states to continue paying EB longer than a state that had the same percentage of workers unemployed but that had never triggered on. That effect could occur because individuals who exhausted their regular benefits would still be counted as unemployed in the first state but not in the second. In 1980 the Labor Department recognized that this practice was unfair and attempted to stop computing the IUR based on EB claims. A federal court, however, ruled that legislation was necessary to make such a change, and the Carter administration asked Congress to do just that (although the actual legislation was enacted during the Reagan administration).

Because of the sound policy reasons for the seven key reforms outlined above, we urge Congress to retain them.

Additional Fine Tuning of EB

We also urge that the following changes be made to fine tune the EB program:

1. Require EB claimants to participate in intensive job search assistance programs. Participation in intensive job search assistance programs should be mandatory for EB claimants, who can be presumed by virtue of 6 months of unemployment to require help with writing resumes, practicing interviewing, and developing job search skills. At present, efforts by the FUTA-funded U.S. Employment Service to teach claimants how to find jobs on their own are regarded as "experimental," although they have proven to be successful in shortening the duration of unemployment and eliminating claimants who have unreported jobs.

2. Deny EB to individuals out of work because of a labor dispute. UC is intended for individuals out of work through no fault of their own, and those individuals who leave their jobs as the result of a labor dispute should not be entitled to draw UC benefits. Although only New York and Rhode Island pay benefits to strikers outright (after a waiting period), court decisions in many other states require that benefits be paid to strikers if the employer is able to continue operations during the strike. Studies show that strikes in New York and Rhode Island end when UC benefits run out. The right to strike is important, but it is unfair to force employers to subsidize their employees who walk off the job. We would oppose a federal standard disqualifying strikers from receipt of regular benefits, but we urge Congress to disqualify EB claimants who are out of work as the result of a labor dispute.

3. Require states with stable unemployment rates to trigger off. The optional trigger allows states that have stable but relatively high IURs to continue paying EB. Because half of EB is FUTA-financed, benefit costs in these states are subsidized by all states. The federal-state UC partnership, in recognition that each state has unique economic conditions, contemplates that each employer and state will essentially pay their own UC costs. However, it is appropriate to pool part of EB (the federal share), in recognition of the national responsibility during economic downturns. Several states

have stable but relatively high unemployment rates, but the optional trigger allows them to continue paying EB long after there is a return to normal economic conditions. Consequently, part of their benefit costs are pooled inappropriately. Puerto Rico's current EB period, for example, began February 23, 1975. We urge Congress to put a limit on how long a state may qualify for EB without meeting the 20% increase requirement.

Other Issues

We oppose the following proposals to change the EB program: (1) use a trigger based on the total unemployment rate (TUR) (S. 1589), (2) trigger benefit extensions for areas smaller than statewide (S. 993), (3) use general revenues or a larger percentage of FUTA revenues to finance a portion of EB costs during periods of high national unemployment, and (4) forgive part of the EB debt.

1. Trigger based on TUR. EB is not payable in states that have low IURs but high TURs. The IUR is a preferable yardstick becase it is a true measure of unemployment among individuals covered by unemployment insurance, whereas the TUR is an estimate that includes many individuals who are unemployed but have not been in the workforce or have exhausted UC benefit eligibility.

2. Area triggers. We oppose the use of area triggers because officials are unable to measure the unemployment rate accurately for areas that are smaller than states, and because the mobility of the workforce makes an area trigger difficult to administer.

3. Use federal general revenues or a higher percentage of FUTA to finance EB. Employers accept financial responsibility for the EB program, and it is fair to split the costs equally between state unemployment tax revenues and FUTA revenues. For the first time in the history of the EB program, the federal government is raising sufficient revenues to meet its share of the costs. The states, however, must also face up to their responsibility for the state share.

4. Forgive part of the EB debt. We do not support forgiveness of the EB debt. We do believe, however, that the $5.8 billion EUCA debt attributable to the Federal Supplemental Benefits program should be charged to general revenues, because benefits paid after 39 weeks should not be an employer responsibility (as Congress recognized when it established the present Federal Supplemental Compensation program). Given the size of the federal deficit, it is unlikely that Congress would charge the entire EUCA debt to general revenues, and the FSB debt is harder to justify as an employer liability than the EB debt.

EB Cost Increases Could Create Hardship

Although there is a sound policy basis for the positions reviewed in this statement, it should not be overlooked that costly changes in EB could create hardships for the states and would have adverse budgetary consequences for the federal government.

Half of EB costs are financed by state unemployment taxes. A record number of states have received interst-bearing federal loans because their UC trust accounts have insufficient funds to meet present benefit obligations. Many of them have raised taxes and restricted benefits in an effort to restore solvency. New, unanticipated benefit expenditures would add pressure for still greater sacrifices in states where economic recovery is barely under way, and may even deprive them of the interest relief and other assistance Congress granted earlier this year.

The federal budget would also be affected. Unless there were offsetting improvements in solvency, higher EB costs would add to the federal deficit because state UC trust accounts and the federal share of EB are included in the unified federal budget.

CONCLUSION

The EB program has worked reasonably well. Following recent changes in eligibility criteria, it is better targeted on those who need an extension. Recent revenue provisions have, for the first time, made the federal share of the EB program solvent. Reforms adopted in 1980 to 1982 are sound and should be retained. Some additional fine tuning is desirable, but we urge Congress to refrain from unwise proposals to trigger EB based on the total unemployment rate or extend duration for areas smaller than states, use general revenues or a larger percentage of FUTA to pay for it, or forgive the EB debt.

STATEMENT OF CHERYL TEMPLEMAN, STAFF ASSOCIATE, UNEMPLOYMENT INSURANCE, INTERSTATE CONFERENCE OF EMPLOYMENT SECURITY AGENCIES, INC., WASHINGTON, D.C.

Senator **Armstrong**. Now Cheryl Templeman from the Interstate Conference of Employment Security Agencies. Glad to have you here. Thank you for coming.

Ms. **Templeman**. Thank you, Mr. Chairman.

First of all, I would like to say that the interstate conference is the organization that represents administrators of State unemployment compensation laws throughout the country.

The recent changes to the extended benefits program, which have been outlined by others here, have resulted in less frequent and shorter extended benefit periods. We believe that the performance of the EB program during this recession has raised questions about whether the current program meets the objective of providing additional weeks of benefits during periods of high unemployment.

As we have heard earlier, there are only a handful of States that are paying EB now, even though there is a public perception that unemployment is high in many other States.

One of the committees of our organization has taken a look at this problem, and believes that a comprehensive review is needed of the extended benefits program. In my prepared statement we list some of the issues that we believe should be examined in such a review. We would be happy to discuss the work we have done already with you and your staff, and happy to work with you in examining these issues.

Unless you have questions, I think the remainder of the remarks you can find in my prepared statement, which I would ask be included in the record.

Senator **Armstrong**. We will be happy to include your statement. I do have a question or two, and we will get back to you in just a moment.

[The prepared statement of Ms. Templeman follows:]

STATEMENT BY CHERYL TEMPLEMAN

STAFF ASSOCIATE-UNEMPLOYMENT INSURANCE

REPRESENTING

INTERSTATE CONFERENCE OF EMPLOYMENT SECURITY AGENCIES, INC.

Mr. Chairman and members of the Subcommitte, my name is Cheryl Templeman. I am the staff associate for unemployment insurance of the Interstate Conference of Employment Security Agencies, Inc. (ICESA). Our organization represents administrators of unemployment compensation laws and public employment offices in the 50 states, the District of Columbia, Puerto Rico and the Virgin Islands. As administrators of the Extended Benefits (EB) Program, we welcome the initiative of the Subcommittee in examining the effect of changes that have been made to the EB program in the past two years. Thank you for this opportunity to present our views.

The Omnibus Budget Reconciliation Act of 1981 made the following changes in the Federal-State Extended Unemployment Benefit program:

- The national EB trigger was eliminated, making extended benefits payable only on the basis of state trigger rates.
- Extended benefit claims were excluded from the calculation of the state EB trigger rate.
- State trigger rates were increased from four percent (plus a 20 percent increase over the prior two years) to five percent (plus the 20 percent factor). The optional state trigger was also increased from five percent to six percent. The higher triggers took effect October 1, 1982.
- A requirement was established that individuals must have worked at least 20 weeks during the base period in order to qualify for extended benefits.

When changes to the extended benefit program were under consideration two years ago we supported elimination of the national trigger and exclusion of EB claims from the trigger calculation. We endorsed permitting states to set higher state trigger levels on an optional basis. We opposed the requirement for twenty weeks of work to qualify for extended benefits.

Since the national trigger was eliminated in July 1981, we believe that experience has shown that action to be a sound policy. Even during the past year, a few states did not experience the high levels of unemployment that plagued most of the country. We continue to support the payment of extended benefits on the basis of economic conditions in each state.

The requirement for twenty weeks of work in the base period in order to qualify for extended benefits went into effect October 1, 1982. Although the impact of this requirement has been small, we continue to oppose this and other federal qualifying requirements for both regular and extended benefits. Most states require at least 20 weeks of work, or the equivalent in wages, to qualify for regular benefits; therefore only a relatively small percent of those who qualify for regular benefits do not qualify for EB. One of the strengths of the UI system is the ability of each state to tailor its UI program to satisfy the social and economic needs of its own labor markets. The small cost saving to the federal government resulting from this requirement does not justify the federal incursion into this area of the UI program.

The exclusion of EB claims from calculation of the extended benefit trigger rates and the higher state trigger levels are separate issues but should be considered together because each has contributed to less frequent extended benefit periods. In addition, in the past several years state law changes have tended to reduce the number of workers eligible for benefits. The combined effect of these changes in the program has resulted in fewer and shorter extended benefit periods than might have been intended. Currently, only eight states are paying extended benefits even though unemployment is perceived to be at high levels in many others.

Whether or not to include extended benefit claims in the calculation of the extended benefit trigger rates is a confusing issue. On one hand, including EB claims would create two definitions of high unemployment. One definition, for triggering "on", would use only regular UI claims, disregarding the number that have exhausted benefits. The other, for triggering "off", would use both regular and extended benefit claims. On the other hand, excluding those claims appears to understate the level of insured unemployment in a state, making it less accurate as a measure of economic distress. The net result, of course, is that excluding EB claims from the trigger calculation has the effect of ending an extended benefit period in a state sooner than it would have if the EB claims were counted.

We have less than one year's experience with the higher state triggers, however, during this short time unemployment has been at record levels. Questions have been raised about whether extended benefits have been available at appropriate times. In many cases, the federal supplemental compensation program has filled the gap where a need for additional weeks of benefits was perceived but extended benefits were not available.

ICESA's Unemployment Insurance Committee has discussed the way that the EB program has functioned in the current recession and believes that a comprehensive review is needed. That examination should include the following:

- Seasonal adjustment of the trigger rates. Do states trigger "on" or "off" due to seasonal factors? Would seasonal adjustment mean that EB is paid at the times it is most needed?
- The time period for computing the trigger rate. Is the 13 week moving average too long or too short a period to use?
- The 20 percent factor. After several years of high unemployment, a state has difficulty meeting this requirement. Conversely in some states with relatively lower unemployment, the rate may double but still be too low to trigger "on".
- Financial Responsibility. Should the federal government bear a larger share of cost of extended benefits where there is a high level of unemployment?

We have done some work on these issues but have not yet reached any conclusions. We will be happy to discuss what we have done with you and your staff, and would be pleased to work with you in addressing these issues.

One final aspect of the EB program that we would like to bring to your attention is the federal work search requirements--added by the 1980 Budget Reconciliation Act. We believe that the Extended Benefit program could be strengthened by modifying the work search requirements. Under the current law, recipients, of EB are required to make an "active and sustained search for work" each week for which benefits are claimed. This means that the individual must visit the place of business of several prospective employers each week and file an application or make an inquiry for work. These requirements are inappropriate in areas where literally no jobs exist. EB recipients must spend money to travel to companies each week when they know the firm is not hiring, and where they have previously filed applications. In many areas there are only two or three major employers, and when they are hiring the word gets around quickly. We have all seen pictures of hundreds of people lining up to apply for a handful of job openings.

In light of these constraints, we urge you to allow states more flexibility in determining work search requirements. States should be allowed to determine what constitutes an appropriate work search for EB recipients, based on local labor market conditions.

In conclusion, we are pleased that the Subcommittee is examining the extended benefit program and the effect of recent changes to it. Thank you for the opportunity to present our comments concerning this important aspect of the unemployment insurance program.

STATEMENT OF BERT SEIDMAN, DIRECTOR, SOCIAL SECURITY DEPARTMENT, AFL–CIO, WASHINGTON, D.C.

Senator **Armstrong**. Bert Seidman from the AFL–CIO has appeared before this committee on many occasions in the past, and we are glad to have you back again.

Mr. **Seidman**. Thank you, Mr. Chairman. I am Bert Seidman. I'm Director of the Department of Occupational Safety, Health and Social Security of the AFL–CIO. I have with me Arlene Gilliam who is the expert in the field of unemployment insurance. She is assistant director of that department.

Let me say, Mr. Chairman, that I do have a full statement, and I would appreciate it if it could be included in the record of the hearing.

Senator **Armstrong**. Yes, of course.

[The prepared statement of Mr. Seidman follows:]

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STATEMENT OF BERT SEIDMAN
DIRECTOR, DEPARTMENT OF OCCUPATIONAL SAFETY, HEALTH AND SOCIAL SECURITY AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS BEFORE THE SUBCOMMITTEE ON SOCIAL SECURITY AND INCOME MAINTENANCE PROGRAMS OF THE SENATE COMMITTEE ON FINANCE ON THE EXTENDED BENEFIT PROGRAM AND INCLUSION OF TAX-EXEMPT INCOME IN THE TAXATION OF SOCIAL SECURITY BENEFITS

August 1, 1983

We appreciate the opportunity to present to this Subcommittee the views of the AFL-CIO on the adverse effect on long-term jobless workers of the changes in the extended benefit program enacted as part of the Omnibus Reconciliation Act of 1981. The AFL-CIO testified in opposition to these cutbacks when they were first proposed by the Reagan Administration and we have urged repeal of the provisions since they were enacted. We will also present our views on S. 1113 which would repeal the requirement that tax exempt income be included in determining whether social security benefits are taxed.

As the result of the economic policies of the Reagan Administration, the number of workers without jobs is at the disastrous levels of the Great Depression and millions of jobs have been eliminated. The search for a job for many, if not most, unemployed workers is a fruitless effort. For June, the Bureau of Labor Statistics reported that 11.1 million workers were without jobs with 10 percent of the labor force officially counted as unemployed. Forty-one percent of these jobless workers had been unemployed for 15 weeks or longer. Of these, almost three million workers had been without work for more than six months. The average duration of unemployment jumped from 19 weeks in April 1983 to 22 weeks in June 1983. In January 1982, the average duration of unemployment was 13 weeks. An additional 7.4 million workers were either too discouraged to search for work or had accepted part-time employment because they were unable to find full-time jobs. Thus, at a minimum, 18.5 million American workers and their families are experiencing severe hardship and economic deprivation.

The protections of an adequate and equitable unemployment insurance system are essential for jobless workers and their families. Yet, of the 11.1 million workers officially counted as unemployed, 6 out of 10 are not receiving unemployment compensation benefits. In February 1975, during the previous worst postwar recession, all but 24 percent of unemployed workers were receiving benefits. Over 4.5 million workers exhausted their regular and extended benefits in fiscal year 1982. Since the beginning of this fiscal year, over 4.2 million workers have exhausted these benefits.

Millions of long-term jobless workers have not even been eligible for extended benefits as the result of the harsh restrictions on the extended benefit program enacted by Congress in 1980 and 1981. In 1980 Congress imposed requirements on all states that:

1. force long-term jobless workers receiving extended benefits to take minimum wage jobs, regardless of skills and previous wage levels;
2. compel a mandatory one-week waiting period before any unemployed worker can get regular benefits as a condition for the state receiving federal help to pay extended benefits to the long-term unemployed;
3. reduce jobless benefits by 50 percent of the pension and social security benefits received by jobless workers;
4. force states to deny extended benefits to workers who "voluntarily" leave their jobs or are fired for "misconduct."

Even harsher restrictions were imposed under provisions of the Omnibus Reconciliation Act of 1981.

The national trigger was eliminated. Prior to enactment of this restriction, up to 13 additional weeks of benefits were paid to workers, regardless of where they happened to live, who exhausted their regular benefits when the national insured unemployment rate (IUR) reached 4.5 percent. In addition, recipients of extended benefits were eliminated from the calculation of national and state trigger formulas and a one percent increase in state trigger levels was required. Before the increase in state trigger levels became effective, workers who exhausted their regular benefits were entitled to extended benefits if the state IUR was at least 4 percent and 120 percent of the state level for the preceding two years. The 120 percent requirement could be waived if the state IUR was at least 5 percent. Now, the triggers which exclude extended benefit recipients are 5 percent with the 120 percent requirement or 6 percent without regard to prior years.

If the national trigger had not been eliminated and recipients of extended benefits were included in the calculation of the national insured unemployment rate, extended benefits would have triggered "on" in April 1982. These benefits would still be available nationwide thus providing extended benefits to an additional 600,000 unemployed workers. Instead, long-term jobless workers are forced to rely on extended benefits being available in their states. However, as the result of the restrictions imposed in 1981 on what were already defective trigger formulas, extended benefits are available in only five states, Puerto Rico and the Virgin Islands and less than 200,000 long-term jobless workers are receiving extended benefits.

Exclusion of extended benefit recipients from the calculation of the IUR has resulted in states triggering "on" extended benefit periods later and "off" earlier. As the proportion of long-term jobless workers grows, thus increasing the number of benefit recipients not counted, the IUR declines while the total unemployment rate remains very high. The AFL-CIO supported by other groups, successfully fought the removal in the courts when the previous Administration attempted to make this change administratively.

While the national total unemployment rate (TUR) is 10 percent, the national IUR is only 4.13 percent, a gap of almost 6 percent. During the 1974 - 1976 recession, this differential averaged 3 percent. For some states, the gap between official unemployment and insured unemployment is even greater than the national average. In Michigan, for example, the differential is 10.6 percent and in Ohio, 8.5 percent. Only three states and Puerto Rico have an IUR of 6 percent. The alternative for continuance of extended benefits is to have an IUR of 5 percent which also must be 20 percent greater than that of two years ago. Large industrial states with high levels of unemployment in the last two years have been unable to meet this requirement despite continued very high levels of unemployment.

As a result, extended benefits are no longer available in such high unemployment states as Alabama, Illinois, Indiana, Michigan, Ohio, Oregon and Wisconsin with total unemployment ranging from 10.2 to 15.2 percent. Twenty-one states have triggered "off" since April 2, 1983. Once a state triggers "off," extended benefits are suspended for 13 weeks regardless of unemployment levels. If extended benefit recipients were included in the trigger calculation and the 120 percent requirement were eliminated but with no national trigger, 18 additional states, including such large industrial states as Illinois, Michigan and Ohio, would be paying extended benefits.

The temporary program of Federal Supplemental Compensation (FSC) which became effective September 12, 1982 has provided some income protection for hundreds of thousands of long-term jobless workers. Unemployed workers who have exhausted either regular or extended benefits are eligible for 8, 10, 12 or 14 weeks of FSC, depending on the state from which they are receiving benefits. Up to 10 additional weeks of benefits were provided for unemployed workers who had exhausted FSC prior to April 1, 1983. Thus, it was possible for workers in some states to recieve 65 weeks of benefits. The maximum duration of benefits for unemployed workers who began receiving FSC after April 1, 1983 is 53 weeks if both extended benefits and 14 weeks of FSC are available in their states. However, since so few states are in an extended benefit period and the duration of federal supplemental benefits is also based on state IURs, very few unemployed workers receive the maximum duration of benefits.

Fourteen weeks of FSC are available only in the three states that have an IUR of 6 percent. As a result of the decline in state IURs in states with disastrous levels of unemployment, only 10 weeks of FSC are available in states such as Michigan, Ohio and Wisconsin, where 14 weeks of FSC had been available in mid April 1983. The maximum duration of benefits in the 27 states where only eight weeks of FSC are available is only 34 weeks.

The income protection provided by the program of Federal Supplemental Compensation is inequitable in that unemployed workers are receiving benefits of varying duration, depending upon where they happen to work or live. A federal program of unemployment compensation benefits, financed from general revenues, must protect unemployed workers equally. This objective cannot be accomplished by relating benefit duration to state insured unemployment rates. It is clear that insured unemployment rates are no measure of total unemployment and are defective measures of the need for extended and federal supplemental benefits. With the gap between total unemployment and insured unemployment continuing to widen, more and more long-term jobless workers are being deprived of benefits.

While establishment of the program of federal supplemental benefits was a much needed step in the right direction, additional steps must be taken immediately to prevent millions of long-term jobless workers and their families from being deprived of all income. As high rates of unemployment continue, more and more workers need the income protection of extended and federal supplemental benefits.

The AFL-CIO has long advocated the establishment of a permanent supplemental benefit program which would provide benefits for the long-term unemployed for at least 65 weeks in all phases of the business cycle. We urge enactment of legislation that would provide at least 26 weeks of federal supplemental benefits without regard to state trigger levels, funded from general revenues. These benefits would be in addition to the current 39 weeks maximum provided under the regular and extended benefits program. In order to assure the widest availability of extended benefits to long-term jobless workers, total unemployment, without regard to the level of unemployment at some prior time, rather than insured unemployment should be used as the trigger.

At the very least, the protections of the extended benefit program that have been eliminated must be restored. Of the almost three million unemployed workers who have been without jobs for more than six months, only one-third are receiving unemployment compensation benefits. By including extended benefit recipients in the calculation of insured unemployment rates, reinstating the national trigger, restoring state triggers to their previous levels and eliminating the 120 percent requirement, hundreds of thousands more long-term jobless workers would receive extended benefits.

The AFL-CIO is convinced that unemployment remains America's number one economic problem. Organized labor has consistently advocated and supported legislative efforts to establish jobs and put people back to work. We still favor this approach to solving the problems of joblessness, but until the goal of full employment is achieved, the federal supplemental compensation program should be extended for at least one year and the defective triggers should be eliminated so that at least 65 weeks of unemployment compensation benefits are available to unemployed workers.

With an adequate and effective unemployment insurance program needed today more than ever before, the program has been drastically weakened so that most jobless workers receive no unemployment insurance. The AFL-CIO urges you to extend and strengthen the program so that unemployment insurance remains through these most difficult times an effective bulwark against deprivation and suffering for all jobless workers and their families.

S. 1113

Under the Social Security Amendments of 1983, taxpayers who have adjusted gross incomes which exceed $25,000 for a single taxpayer and $32,000 or more on joint returns will have their social security and Tier One Railroad Retirement benefits (social security equivalent) subject to taxation. For taxpayers over the base amount, the lesser of one-half of social security benefits or one-half of the excess combined income (adjusted gross income plus one-half of benefits) over the base amount will be subject to income tax. Interest on tax exempt bonds is added to adjusted gross income for the purpose of determining whether an individual's income exceeds the base amount above which a portion of social security benefits would be subject to the income tax.

S. 1113 would repeal the provision of the 1983 Social Security Amendments that requires the inclusion of tax exempt interest income in making this determination. The argument is made that the inclusion of tax exempt income in this manner will discourage taxpayers from investing in state and local government obligations.

The passage of S. 1113 would result in unfair tax treatment in those instances where individuals and couples had tax exempt income as compared to those with equal incomes from other sources. The amount of the tax on social security benefits would vary significantly even though the income and number of dependents were the same. A fair tax should insure that individuals and families of equal incomes pay the same taxes.

The AFL-CIO has long felt that the exemption of this kind of interest is incompatible with the principle of graduated income tax under which all are supposed to pay taxes based on their ability to pay. The current tax exemption on interest is a benefit which almost exclusively benefits the wealthy. In any event, high income groups will still have considerable tax advantages to encourage them to purchase state and local obligations. This is the case even though the equal treatment of this interest income with other income in retirement may result in some taxation of their social security benefits.

Though state and municipal credit has legitimate and important functions, it is doubtful whether its use needs encouragement by a federal subsidy through continuation of this tax exempt feature for retirees. It is extremely unlikely that the credit of these governmental units would be impaired in any way by such a miniscule diminution of this privilege since many other countries do not tax exempt such income at all and without any apparent ill effects.

The Social Security Amendments of 1983 were a compromise arrived at after long and difficult negotiations and legislative efforts. Most groups, including the AFL-CIO, were opposed to some provisions of this legislation. When unsuccessful in eliminating or modifying these provisions, most of them went along with the compromise because it offered the best chance to make the program secure for present retirees and future generations of workers. It would be most unwise to open up this legislation enacted after so much painstaking effort by trying to repeal one of its provisions before its effective date.

We urge the Subcommittee to oppose S. 1113.

Mr. SEIDMAN. And it says—it's developed by an economist with the Joint Economic Committee named Paul Manchester. It's a very simple statistic. It's the total weeks of unemployment. The numbers of workers unemployed times the number of weeks that they have been unemployed. And while total unemployment was going down from May to June, that figure achieved an all-time peak. And the reason for it is that among the unemployed the long-term jobless are becoming a larger and larger proportion.

And then we have the anomaly that benefits for long-term jobless workers are governed by a statistic that regards the long-term unemployed as not existing. And, therefore, we have the situation where these very, very high unemployment States with large numbers of people who have been unemployed a long time are triggering off. And in addition to all that, we have this 120-percent formula, which means that if States already had a lot of high unemployment for a long time then it becomes even more difficult for them to continue to have extended benefits. And also their FSC goes down.

We'd like to see a permanent program of Federal supplemental benefits funded from general revenues, without any regard to State triggers, in addition to the current 39-week maximum. But if that is not possible, then what we would like to see is a shift from using the IUR to using total unemployment, which really measures unemployment. The IUR does not.

And at the very least, the cutbacks which occurred in the extended benefit program enacted in 1981 should be repealed, and the 120-percent requirement should be eliminated.

We think that all of those things are necessary in order to produce anything like a rational program in which the program really meets the objectives that it is intended to meet.

Well, I could embellish on that at great length, Senator Armstrong, but I will resist the opportunity.

Senator ARMSTRONG. It's just evident that you are a very experienced witness. And we thank you for being able to summarize your thoughts.

Mr. SEIDMAN. I would like to introduce this article into the record.

Senator ARMSTRONG. Yes. We would be happy to have that in the record.

Thank you for your statement, and also for the written material.

Senator Long?

Senator LONG. Nothing.

Senator ARMSTRONG. Senator Danforth.

Senator DANFORTH. What is your reasoning for opposing S. 1113?

Mr. SEIDMAN. Well, in the first place, the AFL-CIO traditionally has been opposed to developing what we consider to be tax loopholes. And we have always regarded tax-exempt income as a loophole. As I understand it, this relates principally to municipal bonds.

But in addition to that, in this particular case, this is a tax which would apply to the relatively higher income social security recipients. We weren't in favor of it, but it's in the law now. Those who could afford to have this kind of tax-exempt interest income, we think, would be in the highest brackets.

Therefore, we think that an exemption of this kind would be incompatible with the principle of a graduated income tax under which all are supposed to pay taxes based on their ability to pay.

Senator **Danforth**. Thank you.

Senator **Armstrong**. Mr. King, general revenues of the Federal Government are used to pay for the Federal supplemental compensation program. The States that trigger off the EB program. The supplemental compensation program, in effect, acts as benefit extension. Is the Government really picking up costs that should be an employer obligation in your opinion?

Mr. **Seidman**. I don't believe so. I think that's a question that should be asked. Again, I think the question is what is attachment to the labor? What kind of unemployment are we talking about? Is it something with longer term structure?

And the other point I would like to make is that under the regular EB program the employers are picking up the tab for more than just the employees who would be their employees in their State because half of that program is federally funded. And the States that are in good shape are really helping through not just the employers but everyone else—are helping those States which are getting more of the benefits.

So I don't believe that the FSC is the proper regard to the employer. People who have been unemployed that long generally are not likely to be reemployed in the same trade with the same employer in the same community.

Senator **Armstrong**. Ms. Templeman, you stressed that your organization—that work-search requirements should be more flexible. And that States ought to have the opportunity to vary the requirements, depending on local or State labor market conditions. You state that there are areas where literally no jobs exist. Is that really true? Where there are absolutely no jobs whatsoever.

Ms. **Templeman**. From talking with our members, I am told that that is the case in some areas. In other areas there may be a few employers who have a very few jobs available infrequently. The people who are receiving benefits have filed applications there already. If jobs become available, word will spread like wildfire. It does nobody any good to have people going back to the same employer week after week asking, "Do you have a job opening?" The employers get tired of people flooding their offices when they know there is no employment.

Senator **Armstrong**. You also noted in your statement that we only have a year's experience with the higher State triggers, and that this has been a period of unusually high unemployment.

Let me ask this: I understand that you have a study, your organization has a study, underway that might contribute to our understanding of this issue. Could you tell us when that might be available and whether we could have it for the guidance of this committee?

Ms. **Templeman**. Well, basically, what we have been looking at is the effect of seasonally adjusting the insured unemployment rates for purposes of triggering on or off extended benefits. We have some data that projects in the future which States would be on extended benefits or not if the insured rates were seasonally adjusted.

For example, the projections showed that Michigan would still be on right now if the rates were seasonally adjusted. We felt that before we could make a decision about whether or not seasonal adjustment is good policy that we needed to see some historical data. Going back 10 years or so and comparing the insured rate unadjusted to the insured rate adjusted, and to the total rate. The total rate would be used as a guide to economic distress in the State.

We've had some difficulty getting that data. I believe the data is available, but would take some considerable work on the part of the Department of Labor in order to put it together. So we don't have that available yet. We are still trying to obtain it.

Senator **Armstrong**. Can you give us any guidance as to when it might be available?

Ms. **Templeman**. I'm afraid not.

Senator **Armstrong**. Well, when it does become available, keep us in mind.

Ms. **Templeman**. We certainly will.

Senator **Armstrong**. Thank you.

Mr. Seidman, in your statement you mentioned that the longer term unemployed are constituting a growing fraction of the total unemployment problem, a fact which I think we would all agree on, and which is really a horrible concern to every member of the committee and to all of us who are thinking about this problem.

Perhaps you heard the observations of Ms. Golding earlier that the question in her mind was not so much whether or not we ought to help such people, but the extent to which such help should be borne by the unemployment compensation program. Has the AFL–CIO thought about this issue?

Mr. **Seidman**. Yes, we have.

Senator **Armstrong**. Give us a rule of thumb, or give us a guideline. How long should people be helped through an unemployment compensation type system, and at what point should the burden of that shift, if you feel it should, to some other kind of program?

Mr. **Seidman**. Well, in the first place, we think that there should be a permanent national program, not triggered. A permanent national program which would provide unemployment insurance for up to 65 weeks, depending on the length of time that the person had worked.

In addition to that, we have taken the position that within that period, however, certainly during more normal times, every effort should be made to provide training, labor market services and so on to those workers to get them back on the job as soon as possible. Workers don't want unemployment insurance. Workers want jobs. The problem is there just aren't jobs available today.

In a time like this, provisions of such services might be useful for some workers, and it might not be useful for other workers, and it might not be useful for older workers who couldn't be retrained and so on. You'd have to look at each worker individually.

Beyond that, we think that what is keeping workers who are unemployed for a long time and have exhausted their benefits from receiving any kind of help is primarily the assets test in the welfare laws and in the food stamps program. The assets test in the food stamps program is not quite as rigorous as it is for the AFDC program. But it is vigorous enough so that workers who are what is called the new poor, the people who had decent jobs, who have homes, who have cars or whatever, are unable to qualify under those programs.

So to say that there are other ways of dealing with the problem is no good if those other ways don't exist. And that's what we face. That's why we have the soup kitchens that are inundated with the people who are losing their homes; the workers who face literal loss of 100 percent of their income.

And we think this is an emergency situation. The FSC program is running out on September 30. We think that continuing to use the formula that is being used to determine whether or not a State is on extended benefits just doesn't make any sense. And we would urge that, first of all, the FSC program be extended. And, secondly, that the EB program be changed so that it does bear some relationship to the actual level of unemployment in the State, if we continue the State triggers.

Senator ARMSTRONG. Thank you very much.

Thank you all. We appreciate your statements. Appreciate your help with the bill.

Senator ARMSTRONG. We are now very pleased to welcome our colleague, Senator Al D'Amato, who has introduced legislation, S. 1113, providing that interest on obligations exempt from income tax would not be taken into account in determining the amount of social security benefits to be taxed.

My colleagues will remember that Senator D'Amato brought this matter to our attention on the floor of the Senate recently as an amendment. He has subsequently introduced it as legislation since he was not successful with the amendment, although many of us thought it was a very meritorious suggestion. And this hearing has been convened at his request to explore this and to get some independent outside ideas about this.

Senator, we are happy to have you here today. And before you give us your statement, I just want to congratulate you on your birthday.

Senator D'AMATO. Well, thank you very much, sir. Senator Armstrong, I understand that today you are celebrating your 30th.

Senator D'AMATO. Thirty-ninth.

Senator ARMSTRONG. Well, I heard it was your 30th birthday.

Senator D'AMATO. Well, thank you, Mr. Chairman. That's even more gracious than Jack Benny. But I thought 39, since Jack could do that, well, maybe I could borrow that. And we will keep it at 39 and holding.

Senator ARMSTRONG. Happy birthday.

Senator D'AMATO. Thank you very much, Mr. Chairman.

Senator ARMSTRONG. What about S. 1113? Is it any good?

STATEMENT OF THE HONORABLE ALFONSE D'AMATO, U.S. SENATOR FROM THE STATE OF NEW YORK

Senator D'AMATO. Well, I think S. 1113 addresses a terrible inequity that has taken place in a frenetic finale to passage of the social security compromise, and that's why we have S. 1113. I believe that if the hour not so late and the circumstances not presented a fragile coalition, I would have been prepared to offer an amendment that our distinguished colleague, Senator Long, first brought to the attention of the entire chamber, and which failed by, I believe, a vote of 52 to 44.

Mr. Chairman, I know that the hour grows late, and I do not wish to burden the committee and the chairman by reading a statement that I have prepared. So I would ask that the text of my statement be received as read in its entirety.

Senator Armstrong. We certainly will. And we are glad to have it, and we will put it in the record.

[The prepared statement of Senator D'Amato follows:]

Senator Alfonse D'Amato's—Testimony on Social Security/Municipal Bond Bill

Mr. Chairman, I would like to thank you for the opportunity to testify on my bill, S. 1113, legislation to repeal the inclusion of tax-exempt interest in calculating the income threshold for taxation of social security benefits. The Social Security Amendments of 1983 established an income threshold of $25,000 ($32,000 for a married couple) for taxation of social security benefits. Included in the threshold calculation are taxable earnings, half of all social security benefits, and tax-exempt interest.

This provision was added to the social security bailout package by the two tax writing committees of Congress. It was not recommended by the National Commission on Social Security Reform. I believe that the inclusion of municipal bond interest in the threshold formula is tantamount to a direct tax on previously sacrosanct tax-exempt bonds.

Recognizing the insidious nature of including tax-exempt interest for determining taxation of social benefits, Senator Long raised an amendment to the bill on the Senate floor repealing this provision. Unfortunately, the Senate defeated the amendment by a vote of 52 to 44.

The Congress erred in adding to the Commission's recommendations what amounts to an unconstitutional, improper, and unfair tax to be borne primarily by middle class taxpayers and senior citizens of our society. I believe many Senators voted against the Long amendment without a full understanding of the provision's impact. Many feared that passage of the Long amendment would lead to an unraveling of the entire bailout package.

Although I have serious difficulties with many sections of the social security compromise, my intention in introducing S. 1113 was not to destroy the bailout package. Mr. Chairman, this hearing will help educate those Senators who do not realize the tremendous impact taxation of municipal bonds will have on senior citizens, local taxes, and State and local Government.

As originally conceived, the rationale for including tax-exempt interest in the threshold calculation for taxation of social security benefits was to increase Federal revenues and require the affluent to carry more of the burden. However, the provision fails on both counts.

As a revenue raising measure, including tax-exempt interest in the formula for determining taxation of social security benefits is ludicrous. The Joint Committee on Taxation estimates that this measure will raise a scant $5 million over the next 7 years. Quite frankly, I think that even this figure is overrated. If an individual is just over the income threshold, there exists a real incentive to sell those tax-exempt municipal securities that are priced at a discount. In this way, taxes on social security benefits can be avoided. However, Federal taxes would also be reduced because of the loss from the sale of a security priced at a discount. Thus, Mr. Chairman, the Treasury would actually lose money.

The provision also offers no sense of equity as some proponents claim. The taxable income of the wealthy is already well over the income threshold and, thus, they will pay taxes on their social security benefits even without the inclusion of tax-exempt income in the calculation. Including tax-exempt interest in the income threshold formula, therefore, does absolutely nothing to make the wealthy bear more of a burden. Of course, others are concerned that the wealthy will shift their investments from taxable investments to tax-exempt securities to avoid paying taxes on social security benefits. It is absurd to think that the affluent will incur gains or loses on investments as well as heavy transaction costs just to avoid taxes on social security benefits. For these individuals, social security benefits are nothing more than free money. The provision provides, for some, the fiction of equity, but is just that; fiction.

The middle class elderly of our society will bear the burden of this perceived equity. The individual—that is the senior citizen—put over the threshold by the inclusion of municipal bond interest pays a tremendous penalty. These people purchased tax-exempt securities specifically for their retirement with the understanding and the promise that no Federal taxes would be incurred. For this, the individual absorbed a significant reduction in yield compared to taxable investment. Now, the Federal Government has reneged on its end of the deal and senior citizens are caught in the middle. Existing legislation punishes middle class retirees for investing their savings in the cities in which they reside.

Those individuals that are considering the purchase of municipal bonds for their future retirement will alter their plans in favor of higher yielding taxable securities. And who would blame these people; only a fool would consciously pay taxes on supposedly tax-free securities.

The resultant reduced demand for municipal bonds will have a real impact on the ability of cities and States to raise funds. To attract capital, interest rates will have to be increased. This will result in higher taxes which will be borne primarily by local property owners. This is not an esoteric fact. The municipal finance officers association, who you will hear from later, estimates that municipal bond yields will rise between 25 and 50 basis points simply because of the inclusion of tax-exempt interest in determining taxation of social security benefits. Based on last years securities offerings, the provision will cost cities and States, in aggregate, between $299 million and $598 million.

To the extent possible, local taxes will be raised to recover these costs. However, the taxing power of cities and States is limited. Consequently, some costs will have to be absorbed by a reduction in services. In this age of eroding tax bases and reduced Federal funding, services have already been pared to the bone.

In short, the inclusion of tax-exempt interest in the calculation for determining taxation of social security benefits represents a completely flawed policy. For the first time, municipal bonds are subject to Federal taxation. This will raise, at best, only $5 million over a 7-year period, but will cost State and local government between $299 million and $598 million in higher taxes or reduced services in the first year alone. For the mere appearance of equity, the middle class retirees of our society will be penalized, although the wealthy will not be affected. This is wrong. Thus, S. 1113 is one of my highest priorities.

Unfortunately, the taxation of municipal bonds as mandated by the Social Security Amendments of 1983 is part of a larger trend. The financing avenues available to State and local government has been steadily constricted. Allow me to briefly outline what has occurred:

(1) The recession has eroded the tax base resulting in the deterioration of the credit quality of cities and States. This has reduced the market for municipal bonds and has raised interest costs.

(2) Cutbacks in Federal grants have further exacerbated the decline in credit quality and increased the relative yield on municipal securities.

(3) Reductions in personal tax rates have created an incentive for individuals to enter into taxable activities rather than avoiding taxes. This has also diminished the size of the municipal bond market.

(4) IDB's as a tool for economic development have been limited, and further restrictions are proposed by some.

(5) In response to all these events, cities and States have increasingly employed sale-leaseback transactions to raise funds at reasonable rates. Now, the great taxers here in Washington are attempting to destroy the economic usefulness of this legislative financing vehicle.

Mr. Chairman, we must halt this process. States and cities should not shoulder an unfair share of the burden of reducing the Federal deficit. Savings at the Federal level that simply shift costs on to local government are imaginary savings. In the end, local taxes will rise, services will be reduced, and the middle class destroyed. I believe that the first step in reversing this trend is enactment of S. 1113. Without the tax-exempt status of municipal bonds, our cities and States will be bled dry. We will all suffer in the end.

Mr. Chairman, I again thank you again for the opportunity to testify and I would enjoy your questions.

Mr. Seidman. I would like to record our opposition to S. 1113, which would repeal the provision of the 1983 social security amendments concerning tax-exempt interest income. And we have a fuller statement of our reasons. We are opposing it in our statement.

Senator **ARMSTRONG**. We will incorporate that in that portion of the record.

Mr. **SEIDMAN**. I appreciate that very much.

Mr. Chairman, in the full statement, we have a statement of why we are opposed to this change proposed.

In the limited time that I have, I would like to focus on the unemployment issue today. I will be glad to answer questions on the other.

Mr. Chairman, in June when 11.1 million workers were out of work and 10 percent of the labor force, we found that there was a jump in the duration of unemployment to 22 weeks of average duration of unemployment. What we have had is a situation where very, very slowly total unemployment is going down; where the initial claims for unemployment insurance have been going down somewhat; but where not many workers are being reemployed who have been out of work for a long time.

The result is that while—and this is a statistic—6 out of 10 jobless workers are not now receiving unemployment compensation benefits, only one-third of the nearly 3 million workers who have been without jobs for more than 6 months are receiving benefits. In other words, two-thirds of the long-term jobless, those who have the greatest need for unemployment insurance benefits, are the ones who are not getting unemployment insurance.

Now you have been discussing what you can only regard as the artificial insured unemployment rate as opposed to the total unemployment rate. But I would like to enter in the record an article which appeared in Business Week, which kind of explains the whole thing.

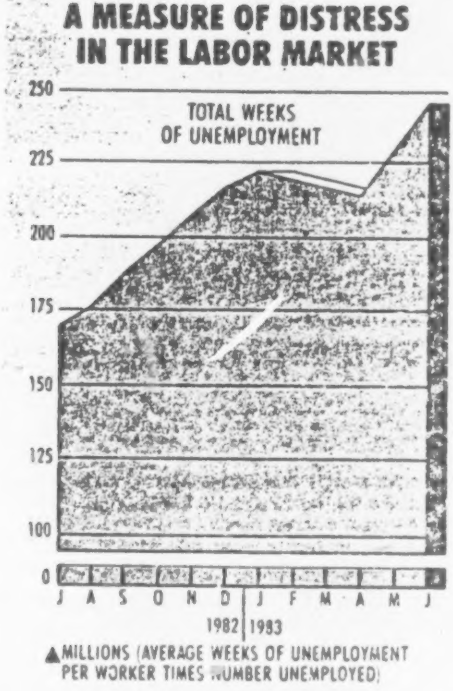
[The article from Business Week follows:]

[From Business Week, July 25, 1983]

THE NUMBERS BRING LITTLE JOY TO THE LONG-TERM JOBLESS

Today's report that the all-worker unemployment rate fell to 9.8 percent in June suggests that job-market conditions are improving significantly, but that does not mean that the hardships associated with joblessness are starting to fade. In fact, one key measure of labor-market distress—total weeks of unemployment—is still rising rapidly (chart).

The measure, developed by economist Paul Manchester of the Joint Economic Committee of Congress, is calculated by multiplying the number of unemployed by the average duration of joblessness. Manchester points out that the measure's big jump in June resulted entirely from a sizable increase in the average length of time without a job—to a postwar record of 22 weeks. "Since the ranks of the jobless actually fell in June," he says, "the indicator is telling us that the current surge in employment is not helping those who have been out of work the longest."



DATA: BUREAU OF LABOR STATISTICS

Manchester notes that at last count 1.6 million people had been without employment for a year or more, nearly 30 times the number in a similar plight as recently as 1969. And the number of persons out of work for 27 weeks or more climbed to a new postwar peak of 2.95 million in June.

"Our labor-market distress indicator suggests that the emotional and economic trauma of joblessness may be with us for some time to come," observes Manchester. "We appear to be faced with a new pool of long-term unemployed workers whose age and experience place them at a disadvantage in an economy that is undergoing rapid structural change."

Senator D'AMATO. But if I might, I would like to touch on the basis of S. 1113. I believe that really what took place was that some well-meaning staffers came up with the idea—and I did not, by the way, loan myself to offering. I understand the staff is somewhat upset. There is a brochure going around that talks about a double-cross. I just heard about this. But, of course, I've always had a pet peeve. And that pet peeve is staff runs the Congress.

And in no instance do I see that situation to a greater extent than some of our own standing committees. And we are all at times guilty because maybe of the volume of work of having an overdependence, an overreliance on staff. They become sacrosanct. My God, it's almost a terrible thing if one Senator talks to another. Imagine that a Senator actually has the temerity to suggest to another Senator that they look at something independent of staff. Incredible. How could that be? And if you are able to win the battle or for the day, you will certainly lose the war because staff will see to it that the thousand and one kinds of things that we have to deal with—that we go out of our way to create problems for the other staffs. And, obviously, the Senators cannot continue to have a dialog day in and day out. And so most of the time we suffer the staff, and we suffer, and we keep quiet.

We are afraid to talk to our brothers, to our colleagues to say to them how about taking a look at that, and how about taking a look at another perspective on this.

I didn't intend to go off on that, but one of my staffers suggested to me that he had heard that the staff here is a little bit upset about an article that was written. I'd like to see it if it upset them or maybe stimulated them. That's pretty good. I can't lay claim to it.

And let me assure you that my staffers are as guilty in attempting to insulate me and attempt me to say that this is the marching order and the drumbeat. I think that's how S. 1113 came up.

At the last minute, the provision that S. 1113 repeals wasn't recognized by the full committee. It seemed like a good idea at first. The provision seems to bring about equity. Everybody wants equity. Everybody wants the big guy to pay his fair share. I certainly do.

By the way, I don't own any municipal bonds. None. No one in my family owns municipal bonds. None. I don't speak from a self-interested point of view. Not at all. Maybe I speak, though, as a result of some 16 years in local government, and I understand when the bond market is up what it means to a little village of 5,300 people that have people from modest backgrounds, doesn't have a great credit rating, and attempts to sell municipal bonds. And I know what happens when rates go up. And I know that our village board then has to increase the property taxes of working middle-class taxpayers to pay that burden. And maybe because I was a town receiver of taxes and also a town supervisor and had to prepare a budget and had rather large issues for local municipalities—the town had about 800,000 people—understand the nature of what takes place in local government.

And maybe I begin to say, "How is it that we have enacted a provision that the Joint Committee on Taxation says will yield only $5 million to the Treasury over 7 years, and the Municipal Finance Officers Association says is going to cost cities and States from 25 to 50 basis points on their municipal securities." We are going to make the municipal bond market unattractive to many people. About 36 percent of all municipal bonds are owned by individuals, and 50 percent of these individuals are over 65. And maybe because I kind of share a belief that the very, very wealthy people are not going to shift out of municipals to avoid taxation of social security benefits. We are not going to get any extra revenues from them because the very, very wealthy will pay these taxes in any event. And they are not going to shift out simply because now they may have an exposure of $7,500 to a maximum of $15,000 of income that will be taxable, that being the social security taxes.

But there are other people who fall in between. And I'm talking about retirees who are middle class, and who this legislation will affect, and who will in effect no longer enjoy the benefits of tax-exempt securities. And I think, by the way, this is a direct assault on the long established principles of indicating that the States will have the right to issue tax-exempt bonds, but they will not be taxed. This is a very real challenge, and a very real assault to that theory.

And so, Mr. Chairman, for just some of those reasons that I have touched on, that I think it's a myth about the equity in the provision. And, oh, I think you can argue the point. You can very successfully go and ask well, why if you have $25,000 worth of income in bonds shouldn't it be taxed? And if somebody has a pension it should be part of the calculation.

Well, we are talking about revenue producers. It seems to me that we are just shifting the burden right back to the middle class working taxpayers. We are not getting at the wealthy. If you want to do that, let's come up with a truly equitable tax code.

The fact remains that those working middle class taxpayers are going to have to pay additional taxes as a result of these bonds being worth less to them. And there are going to be tens and tens of thousands of Americans who are small holders who receive $5,000 or $10,000 worth of income who will no longer find this attractive. This tax-exempt interest income is now calculated into the threshold for taxation of social security benefits.

If you could not demonstrate to me that the provision is a revenue producer—it's a revenue loser. An absolute revenue loser. Municipalities may have to pay anywhere from $250 million to one-half billion dollars in added interest costs. Those are round numbers—more, more in local taxes as a result of the equity myth. And I say it's a myth. And it's very popular. And they want to politicize it and demogog it—if you want to do that, well, you can say we are for equity.

Well, then, let's not go halfway. I would suggest that we deny the tax-exempt status for all municipal bonds. Do away with them. This way, the wealthy can't get by. If that's what we are suggesting, let's do that for all. Let's just destroy the whole tax shelter. But let's not just hurt the middle-class senior citizen.

And then I would suggest to my friends that then there would be at least—that argument can be sustained, I think, more credibly than this attempt at what we call equity. And that could be the only reason that I could see someone really supporting it. As a revenue raiser, the provision doesn't produce revenue. And by the way, people are going to say that lots of people then are going to shift into tax exempts. They have been in—lots of people. We've encouraged lots of people to do that.

And the fact of the matter is that wealthy people are still going to continue. They are not going to drop out—the wealthy people—because of taxation of social security. The ones that will, are the people on the margin. The ones who just get over the threshold as a result of tax-exempt interest being included in the threshold. That's what's going to depress somewhat the ability of cities and States to sell these bonds for local communities when you add that extra factor of cost to it.

And I just simply suggest that this was a political expedient. And that had we taken it to a vote, I suggest that Senator Long knew far better than I did at that hour—but had we had enough time to educate our brethren with respect to this, that we could have reversed that vote on the Senate floor.

And I would hope that in the fullness of time and with some careful study in terms of the total loss of revenues and where it goes, and who gains, that we can again have a full debate and a vote on S. 1113.

I thank the chairman for affording us the opportunity of presenting S. 1113. There are several outstanding experts who would like to talk to this issue from New York—Mr. Lebenthal who is the chairman of the board and chief executive officer of Lebenthal and Co. They specialize in municipal bonds. They are.major municipal bond dealers. And also Mr. Jeff Green, who is the chief of the Finance Division and Law Department of the Port of New York in New Jersey, and is also a member of the Municipal Finance Officers Association and can testify with respect to the factors that they see which will drive up the cost of municipal bonds.

Again, Mr. Chairman, I thank you for affording us this opportunity of moving forward, hopefully, with this legislation.

Senator ARMSTRONG. Thank you very much, Senator.

Senator Long, any questions for Mr. D'Amato?

Senator LONG. Not at this time. But that was a very fine statement.

Senator D'AMATO. Thank you, Senator.

Senator ARMSTRONG. Senator Danforth.

Senator DANFORTH. Well, Senator D'Amato, when we were dealing with the social security bill and this issue of taxing at least some social security benefits, I think that the way the Finance Committee tended to view it was as less as a revenue producer than a move in the direction of means testing social security benefits. Should we exclude, in your view, municipal bond income from determining income levels for the purpose of computing AFDC payments?

Senator D'AMATO. I don't believe that that's the issue here. I think the issue is with respect to social security and no one is suggesting that a means test with respect to food stamps be placed in the same category. I don't argue that.

Senator DANFORTH. That's——

Senator D'AMATO. I think you would find that you are dealing with far different criteria. I don't believe that you would find people who have 10,000 or 12,000 dollars' worth of—a family, for example, of income that comes by way of tax exempts that would qualify for food stamps. You would find other sources of income.

Senator DANFORTH. Why couldn't we make them qualify?

Senator D'AMATO. I would like to—wonder if there were abuses and we could demonstrate some numbers, then I think that we should that that would be the case. But statistically here I don't think you have the same equivalent situation. If you had—and I would suggest to the Senator that would be an abuse—and if I saw that taking place, I would feel similarly. But I don't think that's the situation.

I think the attempt in that particular case is to say if you had a situation that existed there—but I don't think that situation exists. That's a hypothetical that does not exist.

Senator DANFORTH. But the means testing issue is the issue.

Senator D'AMATO. Means testing with regard to where a threshold—this is a new tax and it was determined that social security benefits for the first time would be taxed. You established a threshold of $25,000 or $32,000, fine. But in terms of the income that will be considered, this is the first time that for tax purposes that municipal tax income of any sort is computed in determining at what level the tax would kick. First time. It's a deviation and a departure. It has nothing to do with food stamps means test.

Senator DANFORTH. We will ask Treasury about that. But as I understand it, your position is that with respect to municipal bond income, not only should the bond income itself be exempt from taxation, but for those who are lucky enough to hold municipal bonds their social security should also be exempt from taxation.

Senator D'AMATO. As it relates to this provision of the Social Security Act, yes, they should be—it should be excluded for determining where that threshold develops, yes.

Senator DANFORTH. Well, if a person had say half of a million dollars of municipal bond income, that should be just discounted?

Senator D'AMATO. Well, the fact of the matter is that——

Senator DANFORTH. So there is taxing not on the bond income but the social security?

Senator D'AMATO. Correct. And the reason being, if we were to carry that out, is that you would derive no extra income as a result of imposing this new standard. Again, the Joint Committee on Taxation's own figures said in terms of a revenue producer that you are not going to produce any revenue, but that, indeed, it will wind up costing working middle class taxpayers who pay the bulk of real property taxes anywhere from $250 million to as high as $600 million in extra taxes by way of real property taxes.

It just seems to me that if we want equity, then let's treat the entire subject—and I said this on the floor in terms of reforming the Tax Code, and let's simply say because I would suggest there is something terribly wrong—if I might just complete this subject. Take that same person—$500 million a year income in tax exempts. I think something is wrong when he doesn't pay any taxes whatsoever. I think there should be a minimum tax on that.

But let's go to that issue. I would opt for saying that you have to pay a minimum tax regardless of how many dollars in contribution you have given, how much in municipals you have. I think it's terribly wrong if a person has a million dollars in tax exempt income and then makes other contributions, and uses other shelters and doesn't pay one penny, and we have people like that. Now that's tax equity. That's going after the question.

And I would be willing to undertake that. But to shift into it in this piecemeal fashion, raise no revenue, yet say we are talking about equity when we are not creating equity, I can't subscribe to that.

Senator DANFORTH. Well, I wish you had taken that position last year because, if you remember, you and I had a controversy on the floor.

Senator D'AMATO. But I did. But we did. That's exactly my position. If you check the record, I said if we are going to talk about having a flat tax rate and something similar to what Senator Bradley has put forth, that's one thing. That's going at it directly. That's exactly what I said.

Senator DANFORTH. All right. I——

Senator D'AMATO. I'd look back in the record, and go over it with you.

Senator DANFORTH. Something of a windfall if we are going to say not only is municipal bond income going to be tax exempt, but if you own municipal bonds also your social security is going to be tax exempt no matter how high an income you have.

Senator D'AMATO. Now the Senator knows that we are talking about at the maximum——

Senator DANFORTH. Double bonanza.

Senator D'AMATO. Well, it's not a double bonanza because I would suggest to you that the very wealthy that you are talking about, if that was to be the case, this would be a revenue producer that would be far more than $5 million. And it's simply not. Five million dollars over 7 years. So what did we accomplish by doing that? We will be driving out middle-class bond holders, people who just come over the threshold who will no longer purchase these. We will have a decline in the purchase of municipal bonds, and consequently, we are going to raise the cost.

I don't think that you are going to get anyone of any kind of wealth to give up municipals because of this legislation. But yet people can go around and say we did. I don't see it being achieved here.

Senator DANFORTH. Well, I think if you say that you are going to get a double windfall if you hold municipal bonds, you provide an extra incentive never previously intended in the law or provided in the law. And maybe if you take away the double benefit instead of the usual benefit, people would say, well, we are no longer as well off as we were a few months ago. But I think that they would revert right back to where they have been historically on municipal bond income. It would still be exempt from income taxation.

Senator D'AMATO. I would simply have to ask, then, how was it that the Joint Committee on Taxation estimates that with respect to this measure there would be a net gain of $5 million over 7 years?

Senator DANFORTH. Thank you, Mr. Chairman.

Senator ARMSTRONG. Thank you, Senator Danforth.

Senator Heinz?

Senator HEINZ. Thank you, Mr. Chairman.

Senator D'Amato, do you agree or disagree with the notion that if the income from tax exempt bonds is not included in calculations that determines how much of ones social security benefits are subject to taxation, that there would be an incentive for people who do not have tax exempt obligations but who have taxable obligations to shift from one to the other?

Senator D'AMATO. I think that you would see a certain amount of that, yes, from the unsophisticated, the more unsophisticated investment broker. Yes, I think there would be a stimulation in that area.

Senator HEINZ. I assume that like me you had constituents before this bill actually got to the floor that said, "Senator, you are going to try and tax us on our corporate bonds, and we are simply going to fool you. We are going to buy tax-exempt bonds." I had several say it. I had one say it on a statewide public television. I said, "Thanks for the idea."

Senator D'AMATO. I think it's a very real possibility, Senator.

Senator HEINZ. Is there any other way than the inclusion, if we decided to go along with Senator Chafee's amendment—any other way to address that problem?

Senator D'AMATO. I certainly think that the basic problem is with the threshold establishing a total taxable income on social security. If you have $25,000, for example, or $25,001, that we are now going to tax the whole $7,500. That makes it a little more unpalatable.

I'm going to suggest that something should have been done with regard to that. It certainly doesn't seem fair to me. And then take the couple that makes $31,999, and then they get $14,000 in social security benefits, nontaxed. That's an inequity when the couple that has an income of $32,001, then they have $14,000 worth of social security income that is taxed.

I mean you want to talk about inequities, that's a situation that you would tax. I mean if you hit the threshold, you are going to tax all of the social security income that's over and above? I don't understand that.

Senator HEINZ. I may have misunderstood what you said. Are you suggesting that there is a trigger point here where all income——

Senator D'AMATO. All of your social security income.

Senator HEINZ. All of the social security income. All of the social security income, all of it if you get $1 over the limit becomes taxable.

Senator D'AMATO. Yes.

Senator HEINZ. My recollection is there is a sliding scale. I don't happen to have in front of me.

Senator D'AMATO. Well, I would stand corrected on that if that's the case. I've been given to believe that that wasn't, but——

Senator HEINZ. I believe that——

Senator D'AMATO. I stand corrected, Senator. I stand corrected. But I think there would be a number of people who would definitely opt to go into the municipals as a way of not hitting that threshold. Yes, there is no doubt about that. But I suggest, too, that those are not the wealthy people. And that we are really not addressing them when we talk about tax equity. I suggest to you if we are talking about tax equity that it would be establishing a minimum tax for people based upon a gross income regardless of where their investments were, whether they were in municipals or in others. That's tax equity. This isn't tax equity.

Senator HEINZ. As I seem to recollect the history of the Finance Committee, Senator Danforth indeed tried to do that. And ran into a different Long amendment in the process of trying to so do.

Let me ask you this. I think it is fair to say that the people you are concerned about are a group of who are at this margin.

Senator D'AMATO. That's correct.

Senator HEINZ. I imagine that their marginal tax rate is around 30- percent in that roughly $25,000 to $30,000 bracket. Is it also your position that the enactment of this legislation will make it unattractive to them to hold tax exempt bonds? And that this legislation will depress the market for tax exempt bonds? That would seem to have been an important part of the thrust of your testimony.

Senator D'AMATO. On page 3 of my testimony, I talked to that issue with some specificity. I do believe that you will see people as a result of the high interest rates and relatively low yields that now come about—you will see people who will sell the bonds at discounted rates and that, indeed, that is going to then cost future issuers. It's going to drive up the rate for future issuers. There will also be a Treasury loss with respect to loss of income as they do this. So that is another area of concern that has been expressed to me by municipal finance officers.

Senator HEINZ. When we debated this issue on the Senate floor on March 23, on page S 737 of the record, I attempted to address this point, and put into the record an example. The example compared a $100,000 denomination investment that was hypothetically either a taxable $10,000 year return (10 percent) or a $7,000 nontaxable return. And I won't take the committee's time to go through the analysis, but what that analysis showed is that even with the inclusion of the tax exempt interest for the purposes of calculating how much of the social security benefit would be taxable, there was still a tax advantage. In this case, a $328 advantage to holding the tax exempt bond, brought about basically because you are at the 30-percent rate, margin rate; you are at a 30-percent differential between the $10,000 and the $7,000. But you are on a lower base. That is the $7,000 return is a lower base than the $10,000 return. The difference of those factors is roughly $328 difference.

This proves, I think, that although there might intuitively be a disincentive, in practice there is really an incentive remaining.

Senator D'AMATO. I think it might behoove us to attempt to determine at what levels. For example, at what yields those nonmunicipals and the municipal would function. As you have indicated, you have done this with respect to 30-percent tax bracket, $7,000 yield tax free as opposed to $10,000 at 10 percent. I think it would be important and might prove out beneficial if we got some studies and some statistics to indicate just where those two figures cross.

Senator HEINZ. My question was going to be: Do you yourself have any information on that? If not, perhaps someone—

Senator D'AMATO. I think Mr. Lebenthal would be able to talk to that. I do not, and I would be interested in it.

Senator HEINZ. Thank you.

Senator ARMSTRONG. It occurs to me that the original mover of this amendment was the Senator from Rhode Island.

Senator CHAFEE. It occurred to you correctly.

Senator ARMSTRONG. Do you have any questions at this point?

Senator CHAFEE. We have quite a few other witnesses. I just want to say that I have a little trouble following the reasoning behind the dismissal of the equity issue by the distinguished Senator from New York. For me, the equity issue is the paramount issue. Of course there is some revenue impact, but basically the most important concerns have been outlined by the Senator from Missouri and the Senator from Pennsylvania during their questioning.

Let me present another question to you. As you know, presently there is an earned income tax credit based on wage earnings below certain level. If, for example, a clerk has an income of $8,000, and a group of children and a spouse, he or she will receive the credit. If that person had $50,000 of tax exempt income, the person would still receive the tax credit. How does that strike you?

Senator D'AMATO. Well, Mr. Chairman, I'm wondering how many examples in this entire good Nation of ours you could bring to the floor. So if we are going to talk about situations, hypotheticals that don't exist to any extent, that's one thing. Now if we are going to talk about the realities of the situation which are, I believe, borne out by the statistics that come about from your committee, from your staffers, from Treasury, there is no gain here. You are just going to wind up costing because we create the perception, the illusion, and you can point out examples like this throughout the tax code. But you are going to be creating the illusion of equity. And, indeed, have achieved very little.

I would suggest if we really want to talk about that, then let's get to the business of equalizing what people are able to keep—working people, people who earn money, et cetera—and set up a fair tax code.

Senator CHAFEE. Let's take the problem at hand. If we were the Almighty, presumably, we could straighten everything out. But this committee isn't that. It may think it is sometimes, but it is not.

Therefore, we have got to tackle the problems that come before us. We have been through the example and to suggest that there is no equity in considering tax exempt interest income seems to me to be discounting the facts as they exist.

However, the hour is getting late, and we have got other witnesses, Mr. Chairman.

Senator LONG. I have one question. We talked about equity for a moment. You and I agree, Senator D'Amato, that this device has the effect of taxing the income on State and municipal bonds. There is no doubt about it.

Senator D'AMATO. There's no doubt about that.

Senator LONG. You and I agree on that. Nobody is arguing here that this does not have the effect of taxing the income from their State and municipal bonds.

I don't think there is any doubt if we just take time to focus on it for a while. [Laughter]

In other words, by virtue of the fact that you would get $1 of income from a State and municipal bond and you are drawing social security income, that makes $0.50 of the social security income taxable by the fact that you have got $1 of income from state and municipal bonds. This assumes that your other income is about $25,000. Now, all right, that has the effect of taxing the State and municipal bond income. But if you didn't have that bond income, you wouldn't be paying the tax on the $0.50.

Senator D'AMATO. That's correct.

Senator LONG. Now in terms of equity, once you accept the principle, which to me is indisputable, that this has the effect of taxing the income on State and municipal bonds—once you agree with that, you must recognize that you are only taxing it for people whose income is around $25,000 or $32,000. Twenty-five thousand dollars if you are a single person; $32,000 if you are a couple. Right?

Senator D'AMATO. That's correct.

Senator LONG. All right.

Senator D'AMATO. We have the wealthy people.

Senator LONG. So this is the point. If you really feel—I'm not talking about equity—if you really feel that you ought to tax the income on State and municipal bonds, how in the sake of anything that's fair and just could you justify taxing it for people with incomes around $25,000 or $32,000 while you are not going to tax it for those who have $100,000? You are not going to tax bond income for those that have $1 million of income. You are only going to tax it on these little people who fall around $25,000 if you are single; $32,000 if you are married.

Senator D'AMATO. Mr. Chairman, that's exactly the point. You are absolutely on. And that's what we said on the Senate floor. We said instead of trying this myth about talking about equity, why don't we go after it. I challenge the committee to come up with something to tell us.

I think it's a darn disgrace to have a person who has $100,000 in tax-exempt income that has $200,000—that is a million. I've got a friend. He invests for a friend of his. Now Lebenthal here he is probably going crazy here that I am saying this. But he invests for one of my friends. He has an investment income that he receives from municipals of about $5 million a year. Doesn't pay one penny in Federal taxes. Now that's a disgrace.

Now why don't you make a law that says——

Pardon me?

Senator DANFORTH. You've changed your argument.

Senator D'AMATO. No, I didn't. Oh, no, sir, I did not, Senator. I want to tell you—if you want to come up with something like Senator Bradley has put forth that says across the board, across the board—not just single out municipals, let's look at that. But don't come up with this tax equity, which is not tax equity. You let the rich guys drive a whole truck through, and they are going to keep driving that truck through.

Senator LONG. I'd like to ask just one other question. This has to do with this revenue-shifting matter that Senator Heinz raised.

Now what we are talking about here is where a couple would have about $32,000 of income ($25,000 for a single person). People well above that level wouldn't be affected.

Senator D'AMATO. Right.

Senator LONG. Now $1 of income from State and municipal bonds would make $0.50 of social security income taxable. So with these people being in about a 30-percent bracket, that's the equivalent of a 15-percent tax on the income from their State and municipal bonds. Now when we are talking about the value of tax exempts rather than taxables, in practically all cases, whether municipal bonds are taxable or not, it would serve no purpose to shift to State and municipal bonds because the taxable bond would pay at least 15 percent more income than a tax-exempt. Now is that correct or not?

Senator D'AMATO. That is true.

Senator LONG. So there is no point in revenue shifting. That is, shifting away from taxable over to tax exempt. If you are one of these people making less than $32,000, you would be caught in this situation.

Senator D'AMATO. And so, Mr. Chairman, that's why we have a situation where there is no income derived to the Treasury.

Senator HEINZ. Would the Senator from Louisiana yield?

I think he inadvertently misstated the case. That there is no incentive to be derived from shifting from tax-exempts to other securities. That is what I thought he meant to say.

Senator LONG. There is no incentive for these people to shift from a taxable bond over to a tax-exempt. In other words——

Senator HEINZ. According to the Senator's analysis, there's a 15-percent reason to do so.

Senator LONG. But generally speaking a taxable bond is going to yield you more than 15-percent income over and beyond what the tax-exempt would yield.

Senator HEINZ. That's right.

Senator LONG. So there is no incentive? The point is these people are in about a 30-percent tax bracket. But you are only taxing $0.50 for $1 of income if they buy a tax exempt-bond.

Senator HEINZ. Both tax-exempt and the nontax exempt.

Senator LONG. Well you are talking about $1 making $0.50 taxable. And that being the case, it works out as though you are paying taxes at half the rate. So if you are talking about a tax of 15 percent, the difference in yield is more than 15 percent between the two bonds.

Senator D'AMATO. Mr. Chairman, I just believe that what we are going to see is that many people who heretofore have considered, who have purchased municipal bonds—and I'm not talking about wealthy people, but people who fall into that area up to the $25,000 to $32,000 area—and that tax-exempt income, that $5,000 or $10,000 that they have in bonds—we are talking about small bondholders, relatively speaking. It pushes them into that threshold. That you are going to have a disincentive to continue in this area. It is going to make these bonds more difficult to market. It's going to add an additional cost to them. And we are not addressing the route problems that I think every Senator has spoken to with respect to tax equity.

This is not the answer. It may create the perception when you can say on the stump, well, if you have $25,000 in income that comes from municipals, why shouldn't that be taxable as opposed to someone who has a $25,000 retirement or pension which is taxable. I've heard that argument.

But that really isn't the issue here. That is not the issue. And it doesn't go to the issue of tax equity. And I want to thank the chairman, and my colleagues.

Senator ARMSTRONG. Senator, we thank you for a very interesting and forceful statement. You've got the attention of the committee.

We have some other witnesses, as you know. I hope you will come and join us on the dais. If your schedule permits, you are welcome to join us.

Senator D'AMATO. Thank you, Mr. Chairman.

[Letter from Ronald A. Pearlman to Senator D'Amato follows:]

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

DEPUTY ASSISTANT SECRETARY

AUG 16 1983

The Honorable
Alfonse D'Amato
United States Senate
Washington, D.C. 20510

Dear Senator D'Amato:

This letter is in further response to a question you raised during the August 1 hearing before the Subcommittee on Social Security and Income Maintenance Programs of the Senate Finance Committee concerning S. 1113, your bill to repeal the requirement that tax-exempt interest be taken into account in determining the amount of an individual's social security benefits that are subject to tax.

As you know, the Social Security Amendments of 1983 ("the 1983 legislation") requires that, beginning in 1984, a portion (up to one-half) of social security benefits be included in the taxable income of any taxpayer whose adjusted gross income, with certain modifications, combined with 50 percent of his benefits exceeds a base amount ($25,000 for individuals and $32,000 for couples filing joint returns). For purposes of determining whether an individual's income exceeds the base amount above which a portion of social security benefits are subject to tax, the formula for taxation of benefits requires that interest from tax-exempt investments be added to adjusted gross income. You asked during the August 1 hearing whether, in preparing revenue estimates in connection with the 1983 legislation and S. 1113, the Treasury Department had studied the impact upon the municipal bond market of including tax-exempt income in the social security benefits formula.

In response to your question, I should have explained that in analyzing this formula, we have considered not only its effect upon the universe of persons currently holding tax-exempt bonds, but also the incentive it creates for switching into or out of such bonds. As is explained in more detail below, we believe that the formula as enacted will slightly increase the incentive for social security recipients to own tax-exempt bonds. By contrast, were this formula to be amended to delete tax-exempt income from consideration, current levels of demand for state and municipal bonds could increase significantly. In neither case, however, have we projected any decrease in current levels of demand for tax-exempt bonds. Accordingly, we can see no basis for the representations being made by certain issuers and marketers of these bonds that the formula as enacted will discourage individual investment, increase tax-exempt interest rates, or increase municipal bond issuance costs by "hundreds of millions" of dollars.

Market Effect of Formula as Enacted

The inclusion of tax-exempt income in the benefits taxation formula affects social security recipients differently, depending upon whether or not they are subject to the phase-in portion of the formula for taxation of benefits. (This phase-in range varies depending upon the amount of social security benefits received. Assuming benefits of $10,000, the range covers individuals with incomes other than social security benefits of between $20,000 and $30,000, and couples with incomes other than social security benefits of between $27,000 and $37,000. This range broadens as benefits increase.) Individuals above the phase-in range automatically pay tax on one-half of their benefits and thus are not affected if tax-exempt bond income is included in the benefits taxation formula. These individuals accordingly would have no incentive to sell their bonds to buy taxable investments. Their marginal income tax rates are unchanged as a result of the taxation of social security benefits. Presumably, they would therefore continue to buy and own tax-exempt bonds to the extent that their unchanged marginal income tax rates are lower than the percentage difference between the rates on tax-exempt bonds and comparable taxable securities.

For individuals within the phase-in range, the benefits taxation formula as enacted may create an incentive to invest in tax-exempt bonds. This is true because the formula includes only the stated yield on tax-exempt bonds, instead of a grossed-up tax equivalent yield. For example, in the case of taxpayers whose marginal rates are at or near the percentage spread between rates on tax-exempt bonds and comparable taxable securities, a switch from taxable investments to an equivalent amount of lower-yielding tax-exempt investments will have little effect on after-tax investment income. However, because the switch to lower-yielding securities automatically reduces the total income figure used in the benefit taxation formula, the switch can result in a decrease in the portion of social security benefits that are subject to tax. An example of how this incentive operates to increase the demand for tax-exempt securities was set forth in my testimony on August 1.

In view of the effect of the benefits taxation formula on both classes of individual bondholders, we have concluded that the formula as enacted will neither discourage investment in state and municipal bonds nor, as a corollary, increase tax-exempt interest rates. Indeed, the formula may actually encourage holdings of tax-exempt bonds by some persons.

Market Effect of the Formula if It Were Amended to Delete Tax-exempt Interest

If the benefits taxation formula were to disregard tax-exempt income (as is proposed by S. 1113), it also would have differing effects upon individuals depending both upon their income in relation to the phase-in range for taxation of benefits and upon how much discretion they have to switch investments in their income-producing portfolios.

The immediate effect of such a formula upon the current universe of individual bondholders (assuming, for purposes of argument, no shifts in investment portfolios) would be to create significantly divergent treatment of social security recipients at substantially similar income levels. Couples with $40,000 incomes from taxable investments would be taxed on half of their benefits, while couples with $40,000 incomes from municipal bonds would be taxed on none of their benefits. Obviously, persons required by the formula to pay tax on any portion of their benefits would quickly begin to investigate the tax savings from investing in municipal bonds. It is very likely that significant numbers of social security recipients who are within or near the phase-in range for taxation of social security benefits, most of whom currently do not own tax-exempt bonds, would convert a portion of their investments from taxable securities into tax-exempt securities in order to avoid paying tax on their benefits. The Joint Committee has estimated that such efforts to avoid tax on any portion of social security benefits would reduce federal receipts by $232 million over the next five fiscal years.

Certainly this switch into tax-exempt bonds by persons who currently hold taxable securities would increase the demand for state and municipal bonds. It is crucial to recognize, however, that this heightened demand for tax-exempt bonds would represent an increase over 1983 levels - i.e., an increase over demand prior to the imposition of tax on social security benefits. In effect, this increase in existing levels of demand for tax-exempt bonds would be purchased at the expense of the social security trust funds, by reducing the revenues which we expect to raise through taxation of benefits. In view of the current low levels of reserves in the social security trust funds, we can ill afford to enable high-income individuals to avoid taxation of social security benefits, simply in order to further increase existing levels of demand for tax-exempt bonds.

Of course, we continue to be concerned that the formula as enacted both increases the marginal tax rates and decreases the work incentive of individuals within the phase-in range. We stated in our August 1 testimony that efforts to mitigate these effects are still needed, either through further modifications of the earnings limitation or adjustments of the benefits taxation formula. However, for the reasons set forth above, any such modifications to the formula should not include the removal of tax-exempt income from the benefits taxation base.

I hope that this information is responsive to your question.

Sincerely,

(signed) Ronald A. Pearlman

Ronald A. Pearlman
Deputy Assistant Secretary
(Tax Policy)

Senator **Armstrong**. Next let's call Ronald A. Pearlman, Deputy Assistant Secretary for Tax Policy. Mr. Secretary, don't you wish now you had taken me up on my offer earlier in the day?

Mr. **Pearlman**. I do indeed, Mr. Chairman. I've learned a valuable lesson today.

Senator **Armstrong**. Welcome back. Glad to have you.

Mr. **Pearlman**. Thank you.

STATEMENT OF HON. RONALD A. PEARLMAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Mr. **Pearlman**. Mr. Chairman, and members of the subcommittee, we do have a written statement. I do not intend to read it. We will offer it for the record. I would like, instead, to simply paraphrase and summarize some of our comments.

We strongly oppose Senate bill 1113. We believe that the amendment that was added by the Senate to the Social Security Amendments of 1983, to assure that tax-exempt income will be included in computing the base, is a desirable provision, and we would oppose the repeal of this add-back.

We're concerned about repeal for two reasons. We think that there will be an incentive to convert taxable income into tax-exempt income. And we think, while it is difficult to verbalize and much easier to put pencil to paper, that this incentive is demonstrated by looking at the marginal rate on the social security benefit and not simply the applicable tax rate that is produced when you exclude the taxable item from calculating the base.

But I think that we, in general, would concur with Senators Danforth and Chafee in saying that our greatest concern is with the inequity that's created by making the distinction between taxable and nontaxable income. And we take the example of $25,000 or $30,000 income, which is all taxable on the one hand, and largely tax exempt or fully tax exempt on the other, and suggest that it is not fair that in one situation social security benefits will be taxable in whole or in part, while in the other case the social security benefits will be received tax free.

In our statement, we include an example that demonstrates the relative tax burden of $35,000, which is not, as Senator D'Amato points out, a significant income, and yet the difference at $35,000 with an assumed social security benefit of $12,000 between a fully tax-exempt income and a taxable income is $4,500, which is a very substantial difference. We think the individual with the taxable income is put at a distinct economic disadvantage, which we believe is unfair.

It's our view that this is not a tax on tax-exempt income. Here, as in other places in the Internal Revenue Code, tax-exempt income is merely being utilized in determining the tax on some other item of income.

The joint committee statement uses the estate and gift taxation of tax-exempt obligations as illustrative of this point. We would suggest a couple of other items dealing with the income tax which we think perhaps are more directly relevant.

The first, and I think the most significant, is section 265(2) of the Internal Revenue Code, pursuant to which an investment in tax-exempt income will serve to disallow an interest deduction when indebtedness is incurred to carry the tax-exempt obligations. One can certainly argue that if the interest expense that is incurred to carry a tax-exempt obligation is disallowed dollar for dollar for the tax-exempt income that is earned, that is certainly an indirect tax on tax-exempt income. Yet section 265(2) has been in the Internal Revenue Code for a number of years. To my knowledge, that issue has never been raised, certainly to the point of getting any judicial recognition.

A second illustration that I would like to mention, which is perhaps a bit esoteric for those of us who deal less with the taxation of life insurance companies, is a provision in the Internal Revenue Code, section 809(a), pursuant to which interest is allowed as a deduction in determining the amount of a policyholder's dividend deductible by a life insurance company. An investment in tax-exempt income reduces the allowable interest expense deduction.

In a 1965 Supreme Court case called *Atlas Life Insurance Company,* the Court held specifically that a disallowance of that deduction did not constitute a tax on the tax-exempt income.

So we would suggest that there is precedent currently in the Internal Revenue Code for using the existence of tax-exempt income as a proper measure for determining the tax character of some other item of income or deduction, and that it is our judgment that this does not constitute a tax on the tax-exempt income.

It's also been suggested that the social security amendments will adversely affect the market for future issues of tax-exempt obligations. Our data indicates that most holders of tax-exempt obligations do not, in fact, receive social security benefits. That is, they are not at the age to receive social security benefits, will have insufficient income to invest in a tax-exempt item because the effective yield is too low and their tax rate will be too low to make it beneficial, or will have sufficient other income—in other words, the other end of the spectrum—so that the tax-exempt income is going to have no effect on the extent to which their social security benefits will be taxed.

Our opposition to Senate bill 1113 does not mean that we are not troubled by the formula that is presently contained in the statute because, indeed, the phasein, as in any taxing provision, does cause inequity. In other words, there will always be a point where the next dollar of income is going to trigger tax on both the dollar and on $.50 of benefits. Unfortunately, the phasein in the social security amendments will work that way whether you are talking about tax-exempt income or whether you are talking about just another dollar of taxable income.

Senator CHAFEE. Mr. Chairman, could I ask a question here?

Senator ARMSTRONG. Sure.

Senator CHAFEE. Mr. Secretary, I would like to reinforce this last point you just made. In other words, the phasein problem would occur whether or not the income considered is taxable or was tax-exempt.

Mr. PEARLMAN. That particular point, it seems to me, Senator, would occur whether the formula covered taxable or tax-exempt income. Now I want to go on. But I think it's correct. You question—I would answer you that that has nothing to do with what we are talking about today, except it seems to me to point out that the phase-in problem is a problem that is not unique to items of tax-exempt income. And I guess I could answer you, Senator, that in response to the argument that the fellow with a dollar of tax-exempt income is getting hit with a tax, with the argument that a fellow with a dollar of taxable income is likewise going to get hit with an additional amount of tax on his social security benefits.

But what I really wanted to do was to go on and point out the effect of the combination of the phase-in that is part of the social security amendments, and the reduction in benefits, which, again, has nothing directly to do with Senate bill 1113. But the social security benefit reduces as earnings go up, because of the so-called earnings limitation. When you combine the phase-in and a reduction in benefits, and then you consider the implication of those two consequences on the receipt of tax-exempt income that goes into the calculation of the taxable portion of social security benefits, that can, in some circumstances, produce a tax rate that exceeds 100 percent.

That problem was recognized. That's not a new problem. That problem was raised during the consideration of the social security amendments. At the time, Treasury offered a suggestion to try to deal with that problem. We are concerned by that problem. And we stand ready to work again with the committee if it chooses to deal with that problem, which we believe is really the troublesome issue involved with respect to tax-exempt income.

Mr. Chairman, I would say that probably the problems of Senate bill 1113 are a function of both a phase-in concept and of a reduction in benefits concept. And they will be in part modified as income goes above the phase-in rate, as inflation pushes people into higher income rates. And, certainly, will be reduced to the extent that in 1990 the earnings limitation is relaxed a bit.

We think that the over-100-percent tax problem that we suggest—that I suggested a moment ago—and that we describe in our statement, can be dealt with by modifying the formula as I indicated a moment ago, even though it is a more complex concept. We would be happy to work with the committee if you chose to do that.

Thank you very much. I would be happy to answer your questions.

Senator **Armstrong**. Thank you, Mr. Secretary.

[The prepared statement of Mr. Pearlman follows:]

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STATEMENT OF
RONALD A. PEARLMAN
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SOCIAL SECURITY AND
INCOME MAINTENANCE PROGRAMS
OF THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to present the Treasury Department's views on S. 1113, which would repeal the requirement that tax-exempt interest must be taken into account in determining the amount of an individual's social security benefits that are subject to tax. The Treasury Department opposes S. 1113.

Background:

The Social Security Amendments of 1983 requires that, beginning in 1984, a portion (up to one-half) of social security benefits be included in the taxable income of any taxpayer whose adjusted gross income, with certain modifications, combined with 50 percent of his benefits exceeds a base amount ($25,000 for an individual and $32,000 for joint returns). The proceeds from taxation of social security benefits will be transferred to the social security trust funds. This provision originated as one of the recommendations made by the President's bipartisan National Commission on Social Security Reform. In enacting this recommendation, Congress recognized that taxation of a portion of social security benefits received by taxpayers in relatively high income brackets will be a significant step towards restoring the financial soundness of the social security system.

For purposes of determining whether an individual's income exceeds the base amount above which a portion of the individual's social security benefits are subject to tax, the formula for taxation of benefits requires that interest from tax-exempt investments be added to adjusted gross income. This modification of adjusted gross income generated heated debate last March both on the floor of the Senate and during the Conference Committee's consideration of the House- and Senate-passed versions of the social security bill.

It was recognized during those debates that inclusion of tax-exempt income in the benefit taxation formula has no impact on most individuals who currently hold tax-exempt bonds, because most of these bondholders have sufficient adjusted gross incomes that they would pay tax on one-half of their benefits irrespective of the inclusion of tax-exempt income in the benefit taxation formula. In some situations, however, it would be possible for individuals to reduce their adjusted gross incomes by selling taxable securities and purchasing tax-exempt bonds, thereby automatically reducing what would otherwise have been the taxable portion of their social security benefits. Congress ultimately approved the current benefit taxation formula in order not to create an incentive for individuals to avoid paying tax on some of their social security benefits by shifting from taxable investments to tax-exempt bonds.

S. 1113

S. 1113 would repeal the provision of the Social Security Amendments of 1983 that includes tax-exempt income in the social security benefit taxation formula. Were this provision to be repealed, it is very likely that a significant number of taxpayers who are affected by the phase-in portion of the formula for taxation of benefits (i.e., individuals with incomes other than social security benefits of roughly between $20,000 and $35,000, and couples with incomes other than social security benefits of roughly between $27,000 and $42,000) would convert a portion of their investments from taxable securities into tax-exempt securities in order to avoid paying tax on their benefits. Most of these taxpayers do not now own tax-exempt bonds, because their marginal income tax rates are lower than the percentage difference between the rates on tax-exempt bonds and comparable taxable securities. However, with the advent of taxation of a portion of social security benefits, many of these individuals would be encouraged to buy tax-exempt bonds in order to reduce the base used to determine the amount of social security benefits that will be included in income. Such tactics could have a detrimental impact on the efforts taken in the recent bipartisan Social Security Amendments to restore the social security trust funds to actuarial health. In view of the current low levels of reserves in the social security trust funds, we can ill afford to enable high-income individuals to avoid taxation of social security benefits. The formula for taxing benefits was designed to prevent such conduct.

In designing this formula, Congress determined that individuals with sufficient sources of income other than social security benefits are not overburdened if they are taxed on a portion (up to one-half) of those benefits. Were the formula to disregard tax-exempt income, it would cause divergent treatment of individuals at substantially similar income levels. For example, a couple with $35,000 of adjusted gross income who receives $12,000 of social security benefits would be taxed on $4,500 of those benefits, whereas a couple with $35,000 of tax-exempt income who receives $12,000 in benefits would pay tax on none of their benefits. Under the benefit taxation formula as enacted, however, both couples would pay tax on $4,500 in benefits. The inclusion of tax-exempt income in the formula thus ensures equitable treatment of social security recipients in substantially similar circumstances.

While we recognize some serious problems with the existing benefits taxation formula (which are discussed below), we disagree with critics of the formula who assert that it legally constitutes a tax on the interest on these bonds. In essence, the formula of Code section 86 simply denies an exclusion for social security benefits of individuals with income (including tax-exempt income) above certain thresholds. This provision is similar to other Code provisions that take tax-exempt interest into account for purposes of determining the proper treatment of other tax items. For example, Code section 265(2) operates to deny a deduction for interest paid to purchase or carry tax-exempt obligations. Similarly, Code section 809(a), which effectively determines the deduction for interest credited to policyholders of life insurance companies, may operate to increase a taxpayer's tax as a result of the taxpayer's investment in tax-exempt securities. The Supreme Court has held that this latter provision does not constitute a tax on the tax-exempt interest. (United States v. Atlas Life Insurance Company, 381 U.S. 233 (1965).) None of the three statutory rules imposes a tax on the bond interest itself.

The Treasury Department also disagrees with the argument that the current benefit taxation formula will substantially increase the borrowing costs of issuers of tax-exempt bonds. As noted above, the inclusion of tax-exempt income in the benefits taxation formula principally affects those social security recipients within the phase-in range for taxation of benefits. These persons represent only a very small percentage of individuals currently holding tax-exempt bonds. Most individuals who are tax-exempt bondholders are either not recipients of social security benefits, or have incomes sufficiently above the taxable threshold that they pay tax on half of their benefits, and therefore are not affected if this tax-exempt income is added into the benefit taxation base.

Moreover, it should be noted that even with respect to social security recipients who are within the phase-in range for taxation of social security benefits, in certain cases the imposition of tax on social security benefits may actually create an incentive for social security recipients to invest in tax-exempt bonds. This is true because the benefit taxation formula includes only the stated yield on tax-exempt bonds, instead of a grossed-up tax equivalent yield. For example, in the case of taxpayers whose marginal rates are at or near the percentage spread between rates on tax-exempt bonds and comparable taxable securities, a switch from taxable investments to an equivalent amount of lower-yielding tax-exempt investments will have little effect on after-tax investment income. However, because the switch to lower-yielding securities automatically reduces the total income figure used in the benefit taxation formula, the switch can result in a decrease in the portion of social security benefits that are subject to tax. An individual with adjusted gross income of $30,000 (in taxable bond income) and $8,000 in social security benefits will pay tax on $4,000 of the benefits. If this person were to switch his investments into tax-exempt securities yielding $24,000 per year, he would pay tax on only $1,500 in benefits. Thus, when the potential taxation of social security benefits is taken into account, there would be an advantage from investing in tax-exempt instead of in taxable securities, which may ultimately translate into an increased, rather than a decreased, demand for tax-exempt securities.

The Treasury Department is not concerned about this enhanced incentive to invest in tax-exempt securities. We are, however, very concerned that the current benefit taxation formula not be modified in the manner contemplated by S. 1113, lest an opportunity be created for all taxpayers within the phase-in range to avoid taxation on any portion of their social security benefits.

Treasury's reluctance to support the removal of tax-exempt income from the formula for taxing benefits does not indicate that we think the formula itself is without problems. Indeed, this formula, as does virtually any other phase-in formula in the Code, imposes high marginal tax rates on individuals in the phase-in range who are taxed on a portion between zero and half of their benefits. This happens because an individual in the phase-in range who earns an extra dollar finds not only that the dollar is taxed, but that an additional 50 cents of the social security benefits also are taxed. This problem can become particularly severe if the individual is affected both by the phase-in of the benefit taxation formula (i.e., individuals with incomes roughly between $20,000 and $35,000), and by the earnings test formula for reducing social security benefits. In that case, an individual can find that by earning an extra dollar, not only is he taxed on more than a dollar, but also he loses some social security benefits. In such cases, a person could actually lose money by earning an extra dollar.

This problem was recognized during Congress's deliberations over the social security bill, but solutions were not developed. One step was taken to reduce the adverse effects of this formula by modifying the earnings limitation in 1990. That modification lowers the reduction in social security payments arising from an extra dollar of earned income. The Treasury Department believes, however, that efforts are still needed either to modify further the earnings limitation or to adjust the benefit taxation formula in order to mitigate the effective high marginal tax rates for those in the phase-in range. We would be pleased to work with your Committee to develop such proposals.

That concludes my prepared remarks. I would be happy to answer any questions that you might have.

Senator **Armstrong**. Senator Long.

Senator **Long**. I'm not familiar with your background, Mr. Pearlman. I apologize for that. But how long have you been in Treasury?

Mr. **Pearlman**. I haven't been there very long, Senator. I've been in Treasury since July 5 so I'm a newcomer.

Senator **Long**. Well, I just wondered because my impression is that Treasury has been trying to tax income on State and municipal bonds as far back as I can recall anything about taxation. I can recall when I took taxation in law school, more than 40 years ago, that we had a courageous young New Dealer who was teaching me tax law at that time. And he agreed with the New Deal group, that it was ridiculous to say that Congress couldn't tax the income on State and municipal bonds. And they were just chomping at the bit for a chance to get back into court and see if they couldn't reverse that Pollack decision.

Now are you aware that the Treasury supported efforts to tax State and municipal bonds previously before this committee, during the last Congress?

Mr. **Pearlman**. I am aware that, over the years, going back at least until the 1954 Code, there have been proposals to tax, in one way or another, income on State and municipal obligations.

Senator **Long**. Well, you don't need to worry about being inconsistent with Treasury's position when you are advocating taxing State and municipal bonds. I guess you know that. It's been advocated many, many times. And so you are not recommending a change from the traditional position down there at the Treasury.

But I don't think we should try to tax those bonds. And I would hope the court would oppose it if it is done. I just don't think we ought to tax the interest income on State and municipal bonds. I don't think it serves any purpose here.

But you and I have a difference of opinion, and there is no point in arguing about it. We will take the rest of the day if we do that.

Mr. **Pearlman**. Thank you.

Senator **Armstrong**. Senator D'Amato.

Senator **D'Amato**. Thank you, Mr. Chairman.

I was wondering what impact does Treasury calculate that this new amendment, new provision, will have with respect to the cost for municipal and State bonds.

Mr. **Pearlman**. Senator, I simply have no information on that. I know that the Treasury does share the Joint Committee's view as to what the revenue implications of Senate bill 1113 is, but I simply can't give you any information on whether there has been any Treasury study on the impact on the bond market. I will be happy to communicate that information to you, if there is any.

Senator **D'Amato**. Well, let me ask this. With respect to the revenue gain that's been communicated by the Joint Committee on Taxation, it was calculated to be some $5 million over 7 years. Can you verify that?

Mr. **Pearlman**. Well, as best I can tell—and one of the disadvantages of only being here a month is that my information of what was done at Treasury 6 months ago is not quite as good as perhaps it otherwise would be. But as best I can tell, the $5 million estimate was a so-called static revenue estimate. That is, it did not take into consideration any changes in ownership of tax-exempt obligations that might have been prompted if the legislation had not been enacted. The Joint Committee pamphlet that was distributed today shows a revenue estimate from the bill of some $232 million over a 5-year period.

Our revenue estimators concur in that estimate. And, indeed, I might add that our revenue estimators indicate that this estimate may well be low because of the difficulty in predicting behavioral changes—that is, the difficulty in being able to determine whether people will or will not switch from taxable obligations to tax-exempt obligations, is beyond the precise science of revenue estimating. So there is some concern, at least at Treasury, that a revenue estimate that simply looks at how many tax-exempt obligations are out there today and what the implication might be for a certain age group might be an understatement of the revenue impact. But I can't give you any more information on the $5 million estimate of a year ago.

Senator D'AMATO. Let me ask you. Does Treasury intend to make any kind of study with respect to what the impact of the legislation, as it presently stands, is?

Mr. PEARLMAN. I simply can't answer that question. To my knowledge, it was not our intention to make that study.

Senator D'AMATO. Would it behoove them to do that?

Mr. PEARLMAN. Well, I think that we have a sensitivity to the impact of any tax provision on the bond market. There's no question about that. That is as important to the Treasury as it is to the Congress. And certainly something we should be sensitive to. Whether we should be doing a study, I can't answer that question.

Senator D'AMATO. Well, it would seem to me that when you oppose a bill, you have got to oppose it on some basis that what it will do with respect to revenue one way or the other. Now if, indeed, as the general municipal officers say, that this bill may cost local government as a cost of the increase that they have to pay in interest when they sell these bonds—some of these estimates go as much as $800 million—and given the fact that just last year the Joint Committee said it would raise $5 million—now they say a little more over 7 years—if that was the case, if that was the case, would that change your thinking?

If, indeed, the general municipal finance officers' figures are correct, and that there will be an increased cost to local and State governments of anywhere from $250 million annually to as high as $800 million annually, and if, indeed, indeed, and they say the revenue enhancer that you come up with is in the area of even your figures, your new figures that you give us, would that change your thinking?

Mr. PEARLMAN. No; it wouldn't, Senator. But I don't want to say that in a glib way. I hope I can say that seriously to you. That we really do not look at this bill as a revenue item. I tried to make that point in my preliminary comments. We look at this bill as an equality item. We are not looking at whether it would cost $100 million or 500 million dollars' worth of revenue. We are looking at the fact that taxpayers similarly situated in the income ranges that you discussed are going to be treated differently depending on whether they have tax-exempt income or taxable income if S. 1113 is passed. That's our principal reason for objecting to the bill.

Senator D'AMATO. Thank you very much.

Thank you, Mr. Chairman.

Senator ARMSTRONG. Senator D'Amato, I know you are disappointed that the Treasury doesn't support this bill, but prior to your arrival I established the fact that historically the Treasury Department rarely supports legislation pending before this committee.

I would like to correct the record. I think I told you this morning, Mr. Secretary, that only twice in recent years had the Treasury Department appeared before the Finance Committee to support any proposed legislation. I have checked further. And I am told that I am mistaken. That it is actually three times within the last 3 years that Treasury has testified in support of legislation.

So I would say to my colleague from New York that on the chance he should be successful in getting his bill through, then, subsequently, the Senator from Rhode Island should seek to introduce legislation to reverse the decision, I would assume there is a good chance that Treasury would be in, subsequently, testifying against such a move. [Laughter.]

Senator ARMSTRONG. And with that, I recognize Senator Chafee.

Senator CHAFEE. Well, Mr. Chairman, I don't have any questions, but I want to welcome Mr. Pearlman.

Mr. PEARLMAN. Thank you.

Senator CHAFEE. I understand that you are an assistant to Mr. Chapoton?

Mr. PEARLMAN. I am.

Senator CHAFEE. Good; well, we are glad you are here. I know that we will be seeing a good deal of you. I think you are starting off in a very high tone and following the correct route. We welcome you.

Mr. PEARLMAN. Thank you, gentlemen.

Senator ARMSTRONG. Thank you very much. Thank you, Mr. Secretary.

Senator ARMSTRONG. Finally, the committee is pleased to welcome a panel of patient and expert witnesses consisting of Dr. Paul Craig Roberts—please, panelists, come join us up at the microphones—Dr. Paul Craig Roberts, professor of Political Economy, Center for Strategic and International Studies, Georgetown University; Mr. James A. Lebenthal, chairman of the board, Lebenthal and Co. of New York City, N.Y.; Mr. Jeffrey Green, chief of the Finance Division and Law Department, Port Authority of New York and New Jersey, who is appearing today on behalf of the Municipal Finance Officers Association; and Mr. Robert S. McIntyre, director of Federal Tax Policy, Citizens for Tax Justice.

Gentlemen, we are very pleased to have you. We apologize that we are running a bit behind schedule. But that's just the way things work out around here.

So with that, again, our thanks. And, Dr. Roberts, we are most interested to hear your comments and observations about S. 1113 and anything else you have got on your mind.

STATEMENT OF DR. PAUL CRAIG ROBERTS, PROFESSOR OF POLITICAL ECONOMY, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, GEORGETOWN UNIVERSITY, WASHINGTON, D.C.

Dr. ROBERTS. Thank you, Mr. Chairman.

I have a short statement.

Senator ARMSTRONG. Go right ahead.

Dr. ROBERTS. You will hear from a number of State and local government officials and from municipal bond dealers and their organizations about the effects of the Chafee amendment on State and local finance, and about the desirability of passing the D'Amato bill.

I would like to speak, Mr. Chairman, for another group. The elderly workers, taxpayers and recipients of social security who have been injured the most, and who have the greatest stake in the repeal of this decision.

Haste makes waste. And in the hasty committee markup of the provisions taxing social security benefits it made for disaster. As a result of the 1983 amendments, middle income retirees are about to experience enormous increases in marginal tax rates on their private pension and investment income, increases ranging from 50 to 77 percent. Social security recipients who are still working and have earned income in excess of the social security earnings limitation could face marginal tax rates approaching 115 percent.

For example, retired individuals with $28,000 in adjusted gross income from private retirement plans or savings could jump from a 30-percent marginal tax rate to an effective 50-percent marginal tax rate.

A retired couple with private retirement income of about $38,000 could find its incremental income such as would result from higher savings or a higher interest rate or from part-time earnings—they could find this incremental income pushed from the 28-percent tax bracket to an effective 50-percent marginal tax rate.

These middle income retirees will face tax rates as high or higher than now reserved for single people still in the work force earning taxable income in excess of $81,800, and married couples earning in excess of $162,000.

Moreover, these upper income taxpayers may have large sums of tax-exempt income in addition to their taxable earnings, while middle income retirees are penalized by the inclusion of tax-exempt interest in the benefit taxation formula.

These enormous increases in marginal tax rates on middle-income retirees result from the way the Congress decided to go about taxing social security benefits. The formula for computing the tax on benefits is complicated, and will add another page to the complexity of the tax code. Indeed, it is so complicated that apparently neither the administration nor the Congress fully understood the ramifications. There's an appendix to my testimony which runs through an example for you.

The perversity of the formula results from phasing in the taxation of social security benefits. Take the case of a single retiree currently in the 30-percent bracket. Since the retiree's private income is above the allowable threshold, his or her social security income is subject to tax. For every dollar in private income above the threshold, the recipient has to pay tax on $.50 of social security income until one-half of the social security benefits are taxed.

In other words, above the threshold every dollar of private income results in $1.50 of additional taxable income. That raises the tax rate on a beneficiary's additional dollar of private income from $.30 to $.45. That is, it's a 50-percent marginal tax rate.

This approach to taxation of social security benefits runs counter to the basic policies which were designed to improve the incentives to work and to save. The problem worsens when you consider the interaction of the taxation of benefits with the existing limitation on earned income, which costs retirees $.50 in reduced social security benefits for every additional dollar earned over the allowable amounts by continuing to participate in the work force. In this case, due to the loss of benefits, retirees will experience marginal tax rates on additional earned income in excess of 90 percent.

The highest Federal income tax rates possible are about 97 percent for a single worker at about $25,000 in AGI, and 102 percent for married couples where the spouse receives half of the primary worker's benefit. That would come out at about $39,000 in AGI. This percent for the married couple could be higher if both spouses received near maximum benefits independently. If payroll and State income taxes on additional earned income are taken into account, the marginal tax rates can range roughly from 109 percent to 115 percent. I'm not sure Congress realized what it was doing when it passed that legislation.

What we have here is a form of age discrimination that perhaps manages to avoid technically violating the antidiscrimination laws, but is nonethless vicious in violating the spirit of the law. It subjects the income of the elderly to higher implicit tax rates than younger people face. It places a de facto, if not de jure, tax on a social security recipient's income from State and local bonds. The entire thrust of the social security provision dealing with taxation of benefits is to deny the aged any incentive whatsoever from being independent of the Government.

The taxation of benefits is not needed to keep social security solvent in the near term.

Senator **Chafee**. Well, Mr. Chairman, I notice his time is up so I don't want to delay the hearing. However, it's not clear to me from your testimony whether you are addressing the matter before us or whether you are dealing with the general question of the taxation of the benefits.

Dr. **Roberts**. I'm addressing the matter before us here because you have trapped people, retired people, with income—if they are married couples, incomes between $25,000 and $39,000, and if they are single taxpayers $21,000 to $30,000—you have trapped these people in a phasein range where they experience very high marginal tax rates on incremental income. And when you include the income from tax-exempt bonds in the threshold, then you deny them any relief whatsoever. And so what I am saying does address the problem because I'm pointing out to you what a bad situation you designed for middle-income retired people. And then you apply an unequal provision of the law to prevent them from being able to get out of that.

So I am addressing the problem. I only have a few minutes here, and I will be through with my testimony.

So as I said, taxation of benefits is not needed to keep social security solvent in the near term. In the long term, the savings to the system from taxing the benefits are small compared to the overall social security needs.

If you would face up to the real problem, there would be no need to tax social security benefits at all. What is needed is a change in the formula used to determine the initial benefits received by each new generation of retirees. Future benefits are scheduled to almost quadruple in real terms over the current planning period, under alternative II–A, and to more than double under alternative II–B. For average individuals, real benefits will rise from current levels of about $5,000 to between $12,000 and $20,000 by the end of the planning period. That is real money, not nominal. You have got a very large increase in real benefits.

An averaged married couple with one earner will go from about $7,500 in real benefits to between $18,000 and $30,000.

Now if the benefit formulas are slightly altered to limit the increases in real benefits to between 50 and 100 percent over the period—that is, you could still have a large growth in real social security benefits, 50 to 100 percent growth, then you would have OASDI on a sound long-run basis. You would have a large surplus available to cover a major portion of the looming hospital insurance deficits. The change in the benefit growth is so gradual that current retirees and those near retirement are not affected.

Instead, the 1983 amendments have imposed an onerous tax on current retirees, which papers over the long-run OASDI deficit in a purely cosmetic way. The system remains plagued by a long-run deficit, and no funds are available to transfer to hospital insurance, leaving that program in desperate condition. Because of the failure of the 1983 amendments to address the real problem, the Quadrennial Advisory Council, which is now meeting to consider funding for hospital insurance, is faced with a tremendous task.

Mr. Chairman, I recently testified before the Council, and I request that a copy of my testimony be included in my statement today.

Senator ARMSTRONG. Thank you. We will be happy to do that. And we thank you for your statement. I know that there will be some questions that the committee will like to put to you in a few minutes.

[The prepared statement and testimony before the Quadrennial Council of Dr. Roberts follow:]

Testimony of
Paul Craig Roberts

William E. Simon Professor of Political Economy,
Center for Strategic and International Studies
Georgetown University

Mr. Chairman,

I appreciate the opportunity to comment on Senate Bill 1113 and its impact on the taxability of Social Security benefits.

Under the 1983 Social Security Amendments, taxpayers are required to include up to half of their Social Security benefits in taxable income if their modified adjusted gross income exceeds the threshold amounts of $25,000 for a single individual and $32,000 for a married couple filing jointly. Modified adjusted gross income means adjusted gross income plus half of Social Security benefits plus interest on otherwise tax exempt securities. The inclusion of tax exempt income was not a part of the recommendations of the bipartisan National Commission on Social Security Reform, but originated as a Committee amendment by Senator Chafee. S.1113, introduced by Senator D'Amato, would remove tax exempt interest from the computation.

You will hear from mayors, governors, municipal bond dealers and their organizations about the bad effects of the Chafee amendment on state and local finances and about the desirability of passing the D'Amato bill. I would like to speak for another group. As justified as the states and cities are in feeling injured by the Chafee amendment, it is elderly workers, taxpayers, and recipients of Social Security who have been injured the most and who have the greatest stake in the repeal of this provision.

Haste makes waste, and in the hasty Committee markup of the provisions taxing Social Security benefits, it made for a disaster. As a result of the 1983 Amendments, middle-income retirees are about to experience enormous increases in marginal tax rates on their private pension and investment income, increases ranging from 50 percent to 77 percent. Social Security recipients who are still working and have "earned income" in excess of the Social Security earnings limitation could face marginal tax rates approaching 115 percent.

For example, a retired individual with $28,000 in adjusted gross income from private retirement plans or savings could jump from a 30 percent marginal tax rate to an effective 51 percent marginal tax rate. A retired couple with a private retirement income of about $38,000 could find its incremental income (such as from higher savings, higher interest rates, or part-time earnings) pushed from the 28 percent tax bracket to an effective 50 percent marginal tax rate. These middle-income retirees will face tax rates as high or higher than now reserved for single people earning taxable income in excess of $81,800 and married couples earning in excess of $162,400. Moreover, these upper-income taxpayers may have large sums of tax exempt income in addition to these taxable earnings, while the middle-income retirees are penalized by the inclusion of tax exempt interest in the benefit taxation formula.

These enormous increases in marginal tax rates on middle-income retirees result from the way the Congress decided to go about taxing Social Security benefits. The formula for computing the tax on benefits is complicated and will add another page to the complexity of the tax code. Indeed, it is so complicated that apparently neither the Administration nor the Congress fully understood the ramifications.

The perversity of the formula results from phasing-in the taxation of Social Security benefits. Take the case of the single retiree currently in the 30 percent bracket. Since the retiree's private income is above the allowable threshold, his or her Social Security income is subject to tax. For every dollar in private income above the threshold, the recipient has to pay tax on 50 cents of Social Security income until one-half of the Social Security benefits are being taxed.

In other words, above the threshold every dollar of private income results in $1.50 of additional taxable income. That raises the tax rate on a beneficiary's additional dollar of private income from 30 cents to 45 cents ($1.00 x .30 + $0.50 x .30). This continues until one-half of the benefits are taxed, at which time the effective marginal tax rate drops back down.

This approach to the taxation of Social Security benefits runs directly counter to the basic policies of the Congress and the Administration which are designed to lower marginal tax rates and to increase incentives to work, save, and invest. Once people planning their retirement realize that the penalty for providing a private retirement income in excess of the threshold is to be hit with 50 percent to 77 percent increases in marginal tax rates, their saving rate is going to drop. The result will be to make people even more dependent on an already over-burdened Social Security system.

The problem worsens when you consider the interaction of the taxation of benefits with the existing limitation on earned income, which costs retirees 50 cents in reduced Social Security benefits for every additional dollar earned over certain allowable amounts by continuing to participate in the work force. In this case, due to the loss of benefits, retirees will experience marginal tax rates on additional earned income in excess of 90 percent.

The highest Federal income tax rates possible under this interaction are about 97 percent for a single worker (at about $25,000 in AGI) and about 102 percent for a married couple where the spouse receives half of the primary worker's benefit (at about $39,000 in AGI). This percent for the married couple could be higher if both spouses receive near-maximum benefits independently. If payroll and state income taxes on additional earned income are taken into account, the marginal tax rates can range roughly from 109 percent to 115 percent. One has to ask if Congress realized that it was issuing the elderly an ultimatum -- quit work and stay at home, or pay for the privilege of keeping active and staying productive.

What we have here is a form of age discrimination that perhaps manages to avoid technically violating the anti-discrimination laws, but is nonetheless vicious in violating the spirit of the law. It subjects the income of the elderly to higher implicit tax rates than younger people face. It places a de facto, if not de jure, tax on a Social Security recipient's income from state and local bonds. The entire thrust of the Social Security provision dealing with taxation of benefits is to deny the aged any incentive whatsoever for being independent of the government.

Hasty runs at Social Security are nothing new. In 1972 another Congress managed to double-index the benefits. No one got around to fixing the error until 1977, and the added strain on the system in the meantime helped to bring about the current crisis. And the 1983 legislation will not prevent a future crisis.

The truth is that the 1983 Social Security Amendments will worsen the long-run problem by covering it up for a few more years at the cost of incentives to work and save. The legislation also reflects the static thinking that continues to harm tax policy. The staff that drafted the bill apparently decided to "fix" Social Security at the expense of people who currently have above-average incomes, with no thought about how this approach would affect people's planning for the future.

The taxation of benefits is not needed to keep Social Security solvent in the near term. With the recovery that is unfolding, the system's near-term prospects are even brighter than in Alternative II-A of the 1983 Trustees' Report, under which the OASDI trust funds build a reserve which rises rapidly from 15 percent of annual outgo in 1983 to 20 percent in 1984, 25 percent in 1987, 54 percent in 1990, 115 percent in 1993, and higher levels thereafter through the year 2020. Because of massive infusions from scheduled tax rate increases, reserves would increase even without the taxation of benefits. Furthermore, the 1983 Amendments provide the trust funds with a feature called "normalized tax transfers." This provides for crediting the trust funds with an entire month's income by the third of the month, when the checks are mailed, if the trust funds become depleted. This enables the trust funds to get by with a reserve ratio as low as 8 percent of outlays.

In the long term, the savings to the system from taxation of benefits are small compared to the needs of the overall Social Security system -- about 0.61 percent of payroll over 75 years, about 0.86 percent of payroll toward the end of the planning period. In fact, half of these savings will not be realized. Under current law, there is no indexation of the threshold amounts of $25,000 and $32,000 of income above which benefits are taxed. Over time, millions more retirees will be pushed by inflation above these thresholds, and the tax will fall on retirees with lower and lower income. Congress will have to adjust these thresholds for inflation. In doing so, roughly half the revenues will be lost.

Taxation of benefits should never have been included in the 1983 Amendments. Given that it was included, tax exempt interest should never have been included in the formula that was chosen. The revenue loss to the system from adoption of the D'Amato bill will be only a fraction of the revenue raised by taxing benefits. Only that fraction of retirees caught with earnings in the phase-in brackets would have an incentive to avoid the inflated tax rates produced by the formula.

For middle-income retirees faced with big jumps in marginal tax rates over the phase-in range of the taxation of social security benefits, the D'Amato bill would provide some relief. So would repeal of the earnings limitation imposed on the elderly who continue to participate in the work force. When the 1983 Amendments cleared the Senate, they contained a provision introduced by Senator Armstrong to phase out the work penalty over 5 years beginning in 1990. This was an excellent provision, strongly supported by the elderly and endorsed in the past by President Reagan. It would not have been expensive. The extra outlays from Social Security would have been offset to a significant degree by payroll and income taxes on the added earnings of the elderly. Further, the enormous implicit 50 percent tax rate on earned income by retirees would have been removed. The only flaw in the Armstrong proposal was that it began in 1990 instead of 1983.

Unfortunately, the earnings limitation was restored in conference. I can think of no good reason for the approach that was taken. It seems to have been compromise purely for the sake of compromise. The current earnings penalty reduces benefits by $1 for every $2 earned above the limit, which is currently at $6,600 per year for retirees ages 65 to 69, and $4,920 for retirees under age 65. This benefit reduction is an implicit 50 percent tax rate. Under the 1983 Amendments, that penalty will eventually fall to $1 for every $3 earned above the limit, an implicit 33 percent tax rate. Adding in the payroll tax and Federal and state income taxes, and adjusting for interaction with the phase-in of Social Security benefit taxation (which reduces the apparent 17 percentage point improvement to 13) the highest tax rates will range from about 97 percent to 102 percent instead of from 109 percent to 115 percent. This is not a major improvement. Furthermore, it does not begin until 1990. By 1990, those current retirees ages 63 to 69 who are now subjected to the earnings limit will either be over age 70, at which point the limit does not apply, or dead.

What is needed is a change in the formula used to determine the initial benefits received by each new generation of retirees. Future benefits are scheduled to almost quadruple in real terms over the planning period under Alternative II-A, and to more than double under Alternative II-B. For average individuals, real benefits will rise from current levels of about $5,000 to between $12,000 and $20,000 by the end of the planning period. An average married couple with a dependent spouse will go from $7,500 to between $18,000 and $30,000. If the benefit formulas are slightly altered to limit the increases in real benefits to between 50 percent and 100 percent over the period, OASDI would be on a sound long-run basis, with a large surplus available to cover a major portion of the looming Hospital Insurance deficits. The change in benefit growth is so gradual that current retirees and those near retirement are not affected.

Instead, the 1983 Amendments have imposed an onerous tax on current retirees, which merely papers over the long-run OASDI deficit in a purely cosmetic way. The system remains plagued by a long-run deficit, and no funds are available for transfer to Hospital Insurance, leaving that program in desperate condition. Because of the failure of the 1983 Amendments to address the real problem, the Quadrennial Advisory Council, which is now meeting to consider funding for Hospital Insurance, is faced with a gargantuan task. I recently testified before that Council, and I request that a copy of my testimony be included with my statement today.

APPENDIX

In certain middle-income brackets, the complex formula poisons additional pension, interest and dividend income by adding 50 cents in Social Security benefits to AGI for each additional dollar of other income received, until half of all benefits are taxable.

The complicated formula, which the retired taxpayer would have to compute, works as follows:

> Add one-half of Social Security benefits (SSB) and tax exempt interest to Adjusted Gross Income (AGI); this is the taxpayer's income base (B).
>
> Subtract from this base the income threshold (T) in the law -- $25,000 for a single person and $32,000 for a couple.
>
> Add to AGI the lesser of one-half of the excess over the threshold -- 0.5 x (B-T) -- or one-half of SSB.
>
> This becomes the new AGI for tax purposes.

The problem is that when [0.5 x (B-T)] is less than one-half of SSB, each added dollar of other income results in $1.50 of additional taxable income, increasing the marginal tax rate by 50 percent over the original level. In fact, the additional taxable income can spill into the next higher tax bracket which, in turn, is effectively raised by 50 percent, resulting in even larger increases. Consider a single taxpayer earning $27,000 in taxable income who is thinking of earning an additional $1,000:

			Change
AGI before SSB	$27,000	$28,000	+1,000
SSB	10,000	10,000	
Base (B)	32,000	33,000	
Threshold (T)	32,000	32,000	
B-T	0	1,000	
Taxable SSB	0	500	
new AGI	27,000	28,500	+1,500

The extra $1,000 in income raises AGI by $1,500, effectively raising the tax rate from 30 percent to 45 percent, or to 150 percent of the initial value. (When the individual's income increases so that the ceiling, half of benefits, is reached, the marginal tax rate reverts to normal.)

The most extreme results can produce marginal Federal income tax rates in excess of 90 percent. This occurs when a portion of the old AGI is earned income in excess of the Social Security earnings limitation. Due to the earnings limit, an additional $1,000 in earned income reduces benefits by $500. In the above example, SSB falls from $10,000 to $9,500, and B becomes $32,750 ($28,000 + half of $9,500). Thus, the increase in AGI is $1,375 rather than $1,500, and the marginal tax rate becomes 137.5 percent of the original rate rather than 150 percent. For the taxpayer in the example, the marginal tax rate rises from 30 percent to 41.25 percent. However, to this must be added the implicit 50 percent tax resulting from the loss of benefits, so that the total marginal tax rate becomes 91.25 percent. To that would have to be added the 7 percent payroll tax rate and the marginal income tax rate for the taxpayer's state. The total can easily exceed 100 percent.

The formula for taxing social security benefits is complex, inequitable and unnecessary. There is a simple alternative which can be adjusted to tax roughly the same benefits and produce similar revenues as under the current formula, without the adverse impact on other retirement income.

If half of social security benefits are to be taxed, the simplest method is to have the taxpayer add half of social security benefits to AGI. Because the amount of benefits subject to tax under this method is not affected by changes in outside income, there is no problem with a phase-in's impacting other earnings or raising marginal tax rates by 50 to 77 percent. At worst, some income may spill into the next highest tax bracket. If it is desired to grant relief from this provision to low-income retirees, an appropriate amount of benefits can be exempted. By choosing the exempt amount carefully, this method can be made to yield roughly the same revenue as the current formula.

Testimony Prepared for the Quadrennial Advisory Council on Social Security

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We have heard in recent weeks, and without much justification, that the Social Security problem is "solved" and that the system (at least the Old-Age, Survivors and Disability Insurance portion) is "sound" well into the next century. Congress and the public have breathed an unwarranted collective sigh of relief. Now we hear that the Hospital Insurance part of the Medicare system is running out of money and may not be able to pay benefits by the mid-1980's under bad economic conditions and by the early-1990's under good economic conditions. This is why this distinguished Quadrennial Advisory Council on Social Security is being devoted to Medicare.

What seems to need clarification is what exactly is social security? Workers pay a "social security tax" which is designated to one of three trust funds -- Old-Age Survivors Insurance (OASI), Disability Insurance (DI), and Hospital Insurance (HI). Discussions of the system, however, are often narrowly restricted to the retirement and disability side (OASI and DI). This has led down a dangerous path -- one which paints an overly optimistic picture of the OASDI side of "Social Security," while the medical side is facing continuing and growing deficits of enormous size.

The splitting apart of OASDI and HI for analysis and repair has done a great disservice to the country and has placed this Council in an extremely awkward situation. If the Council accepts this artificial limitation on its authority, it will be precluded right from the start from finding an answer to the current crisis.

It is essential that this nation's Federally mandated retirement system be considered as a whole. A workable solution to the HI crisis can be found only by looking at the total system's aggregate costs and aggregate resources.

You will be offered many options during these hearings, including sharp increases in payroll taxes and greatly increased transfers from general revenues, which means sharp increases in income taxes since there are no general revenues to transfer. Nor are there any programs funded out of general revenue, not even defense, which are large enough to take the cutbacks that would be required to cover the HI deficits.

These are not viable options. The supposed revenue gains from such tax increases would vanish in the resulting economic contraction and surge of unemployment.

In reality, there is only one place to turn. That is to the revenues already promised to OASDI, within the constraints of the existing payroll tax rates. By limiting the future expansion of OASDI to reasonable levels, enough revenues can be freed up to reduce the HI crisis to manageable proportions, that is, to levels at which reasonable changes in premiums and benefits can close the remaining gap. There is simply no alternative.

OASDI benefits per retiree are currently scheduled to grow enormously over time. They are scheduled to grow beyond the initial intent of the system. They are scheduled to grow until they take over most of the functions currently performed by the private retirement system. This excessive growth is unnecessary.

This expanded role is unnecessary. In fact, combined with tax increases needed to fund an unaltered HI, this expansion is technically and substantively impossible and would trigger economic changes which would render the promised expansion of the system unachievable.

The OASDI system cannot expand in this fashion and will be changed at some point anyway. The Council should take advantage of that fact in dealing with the HI crisis. In addition, by recommending an orderly change in OASDI, begun early so that it may proceed slowly and gradually, this Council would be doing the entire system and the entire country, including unborn generations, a great service.

Projected Costs of Social Security

The 1983 reports of the Social Security Board of Trustees contain, for the first time, 75-year projections for the Hospital Insurance program.[1/] Some may say that it is absurd to look at 75-year projections of medical costs. Yet, policy is made on the basis of 75-year projections of OASDI benefits -- another example of the asymmetrical treatment I just mentioned -- and the system is declared sound on the basis of one set of assumptions! The purpose of long-run cost projections is not to give a precise estimate (that is absurd) but to give an indication of the direction the program is going under present law and how many resources must be taxed from workers in order to pay benefits.

Table 1 shows the difference between the combined Old-Age, Survivors, Disability Insurance, and Hospital Insurance (OASDHI) costs and revenues as a percentage of taxable payroll. The last column shows the combined OASDHI system running annual surpluses averaging less than 1 percent of taxable payroll for the next 25 years. That is to say, OASDI surpluses are large enough to cover HI deficits for the next 25 years. After that, however, the combined system runs continuing and widening deficits, which reach 6 percent of taxable payroll by 2025, and over 8 percent by 2035.

One can quarrel over the precision of the cost estimates. Perhaps costs will turn out to be one or two percentage points lower, perhaps higher. What is difficult to quarrel with are the demographics. The same demographics that are driving up OASDI costs are affecting HI. According to projections assumed under the intermediate case Alternatives II-A and II-B,2/ the percentage of the population over the age of 65 will nearly double over the next 40 years from 11.1 percent in 1980 to 19.3 percent in 2025. Furthermore, persons over 65 will be living longer. Today, men age 65 have a life expectancy of 14.3 years and women 18.7 years. By 2010, when the baby boom retires, men age 65 can expect to live another 16.1 years and women 21.3 years. Put another way, about half of our elderly population (and 8 percent of the total population) will be over the age of 80 in less than 30 years! Regardless of whether health care costs increase faster or slower than the rate of inflation, the nation's medical bill will grow substantially as the elderly become a larger proportion of the population. This inevitable and inescapable fact is what will drive up the costs of HI.

What this means is that the OASDHI payroll tax, which will climb to 15.3 percent by 1990, will not be sufficient to pay for benefits as currently structured. Payroll tax rates will have to climb to 23-25 percent under Alternative II-B! The unemployment consequences would be quite serious.

The social security tax increase in 1979 amounted to a $665 increase per worker for 10 percent of the U.S. work force. Most of the increase was due to an extremely large increase in the amount of income subject to tax and, therefore, decreased the after-tax return to labor much more than the one-half of one percent tax rate increase in 1979 would suggest. For example, the median income worker, prior to the law change, had to receive a wage increase of 13 percent to receive a 10 percent after-tax increase. With the new law he had to demand a 14-1/2 percent increase to be as well off, and did! The wage spiral this triggered bore out the dire CBO predictions of a half million lost jobs as a result of the 1977 legislation.3/ Employment and the economy moved downward as a direct result.

The subsequent increases provided in this legislation continued the economy's slide downward with some help from other forces. Between 1980 and 1983, payroll tax rates have risen from 12.26 percent to 13.4 percent. This tax increase has reduced employment by roughly one million, accounting for almost one-third of the jump in unemployment from 7.5 percent to 10.8 percent generally attributed to the 1981-1982 recession.

In fact, not until this year did the labor tax picture brighten enough to reverse this trend. This is the first year of reduced taxes on labor income. The first two installments of the President's tax cuts merely offset the bracket creep due to inflation and the social security tax increases legislated in 1977.

We can already see problems over the rest of the decade as the currently scheduled increases are felt; still to come are payroll tax increases in 1984, 1985, 1986, 1988, and 1990 which will raise the tax rate to 15.3 percent of payroll. This jump should result in another 1.8 million job loss, or between $50 billion and $60 billion in reduced GNP in 1983 dollars. The lost GNP will cost the Federal budget about $15 billion in reduced revenue and a similar amount in higher income support payments.

But these increases are miniscule in comparison to the massive increases implied by the current benefit formula. If the tax must move from 15.3 percent of payroll to 25-30 percent as some of us predict, the results will be more devastating than they were in 1979. Suppose, as the Petersen group argues, the demographics or economic conditions of Alternative II-B are too optimistic. (The 2.0 ultimate fertility rate assumed under II-B is higher than the 1.9 rate being used by the Census.) The payroll tax burden could be astounding, perhaps as high as 40 percent.

The economic "malaise" President Carter spoke of in 1979 will look like rosy times by comparison. I would not attempt to make precise predictions of the impact on employment, investment, or output because the tax changes implied are too large. If social security taxes at the level of 12-16 percent can dramatically disrupt the economy, just think what tax rates double and triple that could do.

I think reasonable people will agree that something must give. The system will simply not survive as it is currently structured. In what follows, my basic premise is that a growing, healthy economy is better for everyone -- young and old, rich and poor -- than a stagnating, sick one. From that follows the only real solution to the Social Security problem, a realistic adjustment of the entire OASDHI system, not merely a temporary quick "fix" of its bits and pieces.

The Role of Social Security

There appear to be two views of the role of social security. One view is that social security's role is to provide a basic floor of retirement income at some adequate real level to forestall poverty and promote financial independence of the elderly. However, retirement income in excess of this adequate basic level would be the responsibility of the individual, who would be expected to save over his working life either as an individual or through a private pension plan. This was the original intent of the System.

Others view social security as a pension program -- indeed, the nation's main pension program -- which should provide a fixed replacement rate or percent of pre-retirement income, no matter how high wages and benefits rise in real terms.

For most retirees today social security is meeting its original goal of providing a basic retirement income. Over time it has become the major source of retirement income for many persons. Left unchecked this trend will continue at the expense of the rest of the economy through higher payroll taxes and greater displacement of private savings.

People retiring in the years ahead, particularly after the year 2000, will be receiving substantially higher initial benefits in real terms than people who retired in earlier years. Even with the adjustments in the 1983 Social Security Amendments, real benefit levels will continue to grow over time.

Table 2 shows the benefits that are promised under current law to single workers (a married worker and dependent spouse would receive 150 percent of the single worker's benefit), who retire at age 65, with three different earnings histories. A low-wage worker is someone who always earned the minimum wage; an average-wage worker is someone who always earned the average wage in social security covered employment; and a high-wage worker is someone who always earned at least the maximum wage subject to social security tax.

In reality there are very few workers who would fit into only one of the three categories during their working careers. Rather, individuals typically start out with low wages which rise during most of their worklife and then flatten out in the years preceding retirement. Data on 1981 primary insurance amounts indicate that most retired workers would have had earnings histories bunched near or somewhat above the illustrative histories of the average worker.4/ Earnings histories can be expected to increase over time as workers acquire higher levels of human capital and, hence, higher real wages, eventually approaching those of the illustrative high-wage workers.

As can be seen in Table 2, social security will soon cease to be a basic retirement system which provides an income floor to be supplemented by personal savings and private pensions. With real wage growth of 2 percent per year, the initial benefit *in real terms* of each type of worker at least *triples* over the next 75 years; under real wage growth of 1.5 percent, the real benefits at least *double*. Although people retiring in the years ahead are scheduled to receive substantially higher benefits in real terms than people who retired in earlier years, this does not mean that the system will be a good thing for today's young workers. Benefits will rise, but tax rates will rise even faster. The high tax rates needed to support the benefit structure will make very high future benefits a bad bargain for future retirees.

Economic Effects of Social Security

In addition to being a bad bargain for future workers, social security will be bad for economic growth. The high tax rates will make contributions to personal saving and private pensions at best difficult, and impossible for those who lose their jobs because of the detrimental employment effects of the payroll tax. Reduced availability of labor will lower the productivity of capital and result in less saving and investment with ominous implications for economic growth. Lower economic growth reduces wages and employment, further reducing the income of current workers, and thereby lowering the revenues of the social security system. This requires higher tax rates to finance social security benefits. A higher tax burden further stifles the economy, and so on, in a self-defeating, vicious circle. Practically speaking, social security as currently designed is completely unaffordable.

Social Security is not a Pension Program

Social security may seem to resemble a personal savings or private pension program, especially since the system has adopted the jargon of the private sector to describe its operations. Jargon and semantics aside, however, there is a crucial and fundamental difference between social security and true savings.

Private savings are needed to generate private capital for investment which, in turn, leads to economic growth. Retirees under fully funded private pensions receive a share of the added GNP their savings have created. Because their savings caused GNP to rise, retirees are only taking back what they have created. They do not take a portion of the output or reduce the living standards of current workers.

Social security, on the other hand, is not a pension or a form of national savings. To call it a saving or pension plan is a major conceptual error. Social security is an involuntary, unfunded system of taxes and transfer payments. Taxes paid by current workers are used to finance the benefits paid out to current beneficiaries. No capital formation or added GNP results. Current beneficiaries take a share of the production and reduce the income of current workers.

Are There Any Real Solutions?

The 1977 social security "fix" was heralded as assuring the system's solvency for the rest of the century. By 1978, the OASDI Trustees' report was issuing warnings of potential problems before the decade of the 1980s was over. With each passing year the moment of reckoning grew nearer until another "fix" was needed in 1983. These fixes relied heavily on tax increases of one form or another. They did not, however, grapple with the basic problem of social security -- a benefit formula which promises ever increasing real benefits to a portion of the population that is rapidly growing relative to those who are working. Moreover, these fixes totally ignored the Medicare side whose future deficits are very alarming.

An analogy may be drawn between social security and a drug addict. Pain induces the sufferer to seek a "fix." Almost immediately there is a sense of well-being, even exhilaration. Then, as the "fix" wears off the pain returns, only somewhat worse than the previous time, and another fix is needed. The cycle continues indefinitely until the user decides to quit or until he dies. The longer the user waits to face up to his problem, however, the more painful the withdrawal process. Regardless, "cold turkey" is infinitely preferable to the alternative.

Fortunately, we are still at a stage where we can face up to the social security problem with a solution that will hold harmless those now receiving social security or close to retirement, will allow today's workers adequate time to make adjustments, and will minimize damage done to the economy.

Before doing that let us first examine one common proposed solution. Proponents say, " OASDI is fine. The 75-year Alternative II-B surplus is 0.02 percent. The real problem is Medicare. Because medical benefits are related to one's state of health and not earnings, let's use general revenues to solve Medicare's problem."

Well, first OASDI is not fine. This statement is based on a 75-year average of the system's surpluses and deficits, which is nearly zero under Alternative II-B. Closer examination shows, however, that OASDI runs surpluses in the first 25 years or so and then runs continuing and growing deficits. What happens when the revenues built up in the first 25 years are drawn down? A pay-as-you-go system is sound only if income and outgo are equal on an annual basis. We need only look to recent history to see what happens to reserves that are supposed to be building for future retirees. They are spent, or disappear in recessions they help to trigger. Thus, part of the system's long-run deficit is due to OASDI, which still needs fixing in spite of the 1983 Amendments and the apparent balance of the artificial and misleading 75-year summary statistic.

Even more important, there are no general revenues to spare. All that is being put forward here is a proposal to increase the income tax (or some other form of tax). Such a tax increase would also have damaging economic effects, not only on employment, but in particular because of the double taxation of savings.

Furthermore, general revenues are already being used in Medicare and at an ever increasing rate. General revenue contributions to the Supplementary Medical Insurance (SMI) program (part B of Medicare) have increased from $623 million in 1967 to $13.3 billion in 1982.[5/] The SMI Trustees' report estimates about $19 billion will be needed in 1985. Although long-term projections of SMI costs are not made, it is safe to assume that they will experience the same growth as HI. In 1982 HI benefit payments amounted to $35 billion and SMI to $15 billion, or 43 percent of HI. The SMI tax burden, therefore, could be equivalent to an additional 3-4 percent of taxable payroll.

Any real solution to social security's predicament must be done within the framework of the entire OASDHI and SMI systems. In 1982, social security cash and medical benefits amounted to 7 percent of GNP. The share of GNP devoted to social security will rise to 7.8 percent by 2010 and to 9.7 percent by 2020 under Alternative II-B. Where will the extra 2-3 percentage points of GNP come from?

The answer is that they should not be necessary. Rather, this nation must restructure social security so that the pension benefits are returned to their original intent -- a basic floor providing an adequate amount of income support supplemented by private pensions and savings. Doing so frees up resources that can then be used to finance medical benefits and reduce the pressure for added tax increases. Minimizing the extent to which additional tax increases are required, in turn, minimizes further damage to the economy.

How can this be done? Earlier I said that current beneficiaries or those near retirement would not be affected, nor should they be because they do not have time to adjust for changes in promised benefits. They should not be penalized through reductions in the cost-of-living adjustment (COLA). Social security should assure that the real value of a beneficiary's initial benefit be maintained over time. The COLA is not the culprit.

The problem is the basic benefit now promised under current law. The benefit formula through the mechanism of wage-indexing bend points and earnings histories holds constant the ratio of promised initial benefits relative to pre-retirement wages for successive retiring cohorts. Thus, as the standard of living rises with economic growth, so do real benefits. This leads to the doubling and tripling of benefits in 1981 dollars that is shown in Table 2.

The social security system will continue to be in crisis as long as it promises to pay initial real benefits that rise along with real wages. A way out is to slow (not eliminate) this scheduled rise in real benefits. Switching from wage-indexing the bend points to price-indexing the bend points, as recommended in the 1976 Hsiao report,[6/] would accomplish this slowing in a very gradual way. Real initial benefits would continue to grow, just not as fast as is now the case.

Table 3 shows the initial benefits that could be expected if price-indexing the bend points began in 1990. While current law benefits shown in Table 2 would double or triple (depending on the real wage growth), under price-indexing they would less than double (with the exception of the high-wage worker under Alternative II-A).

While I was Assistant Secretary for Economic Policy, Treasury requested from the Social Security Administration (SSA) estimates of savings that could be gained from various price-indexing proposals. These estimates, which were prepared on the basis of 1981 law, prior to enactment of the 1983 Amendments, showed OASDI costs as a percentage of taxable payroll about 30 percent lower by the end of the projection period under price-indexing the bend points beginning in 1990.

Unfortunately, I do not have similar estimates for the new 1983 law. However, I have prepared rough ballpark estimates by assuming the same relation as in 1981 between the costs of wage-indexing vs. price-indexing the bend points, and applying that relationship to OASDI costs contained in the 1983 Trustees' report. Table 4, which presents the OASDI savings from price-indexing the bend points in 1990 (as derived from this method), provides an indication of the extent to which the combined OASDHI deficit reported under Alternative II-B in the 1983 Trustees' report may be reduced.

Replacing wage-indexing with price-indexing of the bend points beginning in 1990 would result in OASDI savings that would offset approximately one-half the OASDHI deficit. Slightly larger savings would result if the change were made in 1985. Additional savings could be achieved by price-indexing the earnings histories as well. A smooth transition for current workers could be made by wage-indexing earnings prior to the changeover date (e.g., 1990) and price-indexing earnings thereafter. Unfortunately, I cannot provide any precise estimates. However, this Council could obtain such estimates from the actuaries in the Social Security Administration and the Health Care Financing Administration (HCFA), based on current economic and demographic assumptions. I have compiled in Appendix B a suggested list of items that might be of interest and could be supplied by SSA and HCFA.

To conclude: What is needed is a comprehensive solution for OASDHI, which will begin running deficits shortly after the turn of the century. An economically sound solution is summarized as follows:

1. Transfer current OASDI surpluses to HI by reallocating tax rates across trust funds. This should cover HI for 25 years.
2. Slow the growth of outyear OASDI benefits by switching from wage-indexation to price-indexation of the bend points and earnings histories, preferably in 1985, but no later than 1990. Transfer the additional outyear OASDI surpluses to HI. This should more than balance OASDI in perpetuity and reduce the remaining HI deficits to manageable size.
3. Gradually increase HI premiums. Restructure benefits to require partial copayment by recipients up to some percent of income. This would encourage recipients to help control the costs of medical care through avoidance of unnecessary treatment and careful shopping for less expensive providers. These savings should be set large enough to balance the remaining deficits while providing total coverage, including catastrophic coverage, for all expenses in excess of the chosen percent of income.
4. Compensate current and future workers for the slower growth of outyear benefits by expanding IRAs over time. The added personal savings will make the economy stronger and be self-financing. The stronger economy will further reduce the system's deficits.

Table 1

Estimated Cost Rates and Total Income Rates for the OASDI and HI Programs Under Alternative II-B (as a percentage of taxable payroll)

Calendar Year	Cost Rate OASDI	Cost Rate HI	Cost Rate Total	Total Income Rate	Surplus or Deficit
1983	11.39	2.70	14.19	13.97	-0.22
1985	11.33	2.88	14.22	14.28	0.07
1990	11.27	3.46	14.73	15.61	0.88
1995	10.65	4.05	14.70	15.69	0.99
2000	10.08	4.58	14.66	15.68	1.03
2005	9.90	5.13	15.03	15.69	0.66
2010	10.31	5.61	15.92	15.72	-0.20
2015	11.43	6.22	17.65	15.78	-1.87
2020	12.76	7.00	19.77	15.86	-3.91
2025	13.96	7.89	21.85	15.92	-5.92
2030	14.73	8.65	23.38	15.98	-7.40
2035	15.16	9.10	24.26	16.02	-8.24
2040	15.17	9.29	24.47	16.04	-8.43
2045	15.17	9.32	24.49	16.06	-8.43
2050	15.27	9.35	24.62	16.06	-8.55
2055	15.40	9.37	24.77	16.07	-8.69
25-year averages:					
1983-2007	10.67	4.02	14.69	15.37	0.68
2008-2032	12.63	7.08	19.71	15.85	-3.86
2033-2057	15.23	9.29	24.52	16.05	-8.47
75-year averages:					
1983-2057	12.84	6.79	19.64	15.76	-3.88

Source: 1983 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Table F3, page 121.

Table 2

Growth in Initial Real Social Security Benefits For a Single Worker Retiring at Age 65 Under Present Law (in 1981 dollars)

	Low-Wage Worker	Average-Wage Worker	High-Wage Worker
	Alternative II-A (2.0% Real Wage Growth)		
1990	$ 4295	$ 6460	$ 8673
1995	4897	7278	10057
2000	5250	7926	11369
2005	5420	8236	12249
2010	5928	9068	13888
2015	6480	9984	15584
2020	6796	10470	16448
2025	7285	11239	17703
2030	8020	12374	19500
2035	8832	13625	21477
2040	9722	15001	23655
2045	10704	16515	26043
2050	11784	18182	28670
2055	12974	20017	31564
% change 1990-2055	202	210	264
	Alternative II-B (1.5% Real Wage Growth)		
1990	3858	5805	7785
1995	4104	6192	8526
2000	4356	6581	9391
2005	4388	6674	9851
2010	4677	7170	10879
2015	4990	7703	11892
2020	5104	7881	12224
2025	5338	8255	12826
2030	5735	8868	13777
2035	6161	9528	14800
2040	6618	10234	15895
2045	7110	10994	17074
2050	7638	11811	18341
2055	8204	12687	19701
% change 1990-2055	113	119	153

Source: Social Security Administration, Office of the Actuary, estimates prepared in August, 1981. The benefit levels have been adjusted downward to take account of the higher retirement ages passed in the 1983 Social Security Amendments.

Table 3

Growth in Initial Real Social Security Benefits for a Single Worker Retiring at Age 65 Under Price-Indexing the Bend Points Beginning in 1990 (in 1981 dollars)

	Low-Wage Worker	Average-Wage Worker	High-Wage Worker
	Alternative II-A (2.0% Real Wage Growth)		
1990	$ 4295	$ 6460	$ 8673
1995	4709	7151	9713
2000	4922	7597	10456
2005	4897	7710	10796
2010	5167	8047	11785
2015	5462	8356	12769
2020	[illegible]	8283	13015
2025	[illegible]	8422	13548
2030	6198	8802	14458
2035	6655	9223	15459
2040	7157	9687	16559
2045	7472	10196	17762
2050	7756	10756	19086
2055	8072	11373	20543
% change 1990-2055	88	76	137
	Alternative II-B (1.5% Real Wage Growth)		
1990	3858	5805	7785
1995	4055	6144	8382
2000	4171	6401	8888
2005	4087	6374	8990
2010	4236	6729	9658
2015	4398	6975	10253
2020	4387	6829	10241
2025	4477	6849	10444
2030	4702	7055	10918
2035	4941	7277	11424
2040	5199	7515	11967
2045	5476	7771	12552
2050	5772	8045	13180
2055	6091	8339	13856
% change 1990-2055	58	44	78

Source: Social Security Administration, Office of the Actuary, estimates prepared in August, 1981. The benefit levels have been adjusted downward to take account of the higher retirement ages passed in the 1983 Social Security Amendments.

Table 4

Effect of Savings from Price-Indexing Bend Points of Initial Benefit Formula Beginning in 1990 on Reducing the Combined-OASDHI Deficit Under 1983 Trustees' Alternative II-B Assumptions

Calendar Year	Percentage Reduction in OASDI Costs Under Price-Indexing*	OASDI Savings as a Percentage of Taxable Payroll**	Present Law OASDHI Surplus or Deficit	Remaining Surplus or Deficit After Savings From Price-Indexing
1990	0.0%	0.00%	0.88%	0.88%
1995	0.4	0.04	0.99	1.03
2000	1.4	0.14	1.03	1.17
2005	3.1	0.31	0.66	0.97
2010	5.7	0.58	-0.20	0.38
2015	8.7	1.00	-1.87	-0.87
2020	11.8	1.50	-3.91	-2.41
2025	14.6	2.04	-5.92	-3.88
2030	17.2	2.53	-7.40	-4.87
2035	19.6	2.97	-8.24	-5.27
2040	21.8	3.31	-8.43	-5.12
2045	24.0	3.64	-8.43	-4.79
2050	26.3	4.02	-8.55	-4.53
2055	28.6	4.40	-8.69	-4.29

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* Derived from Cost Estimates prepared by the Social Security Administration, Office of the Actuary, August, 1981.

** Reduction factors in column (2) applied to OASDI Cost Estimates contained in Table 1.

FOOTNOTES

1/ 1983 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance Trust Funds, Appendix F.

2/ OASDI Report, Tables 11, A1.

3/ Congressional Budget Office, "Aggregate Economic Effects of Changes in Social Security Taxes," Technical Analysis Paper, August 1978.

4/ Social Security Administration, Social Security Bulletin Annual Statistical Supplement, 1981, Table 56.

5/ 1983 Annual Report of the Board of Trustees of the Federal Supplementary Medical Insurance Trust Fund, Tables 5 and 6.

6/ Report of the Consultant Panel on Social Security to the Congressional Research Service, Prepared for the Use of the Committee on Finance of the U.S. Senate and the Committee on Ways and Means of the House of Representatives, August 1976.

APPENDIX A

The Determination of Benefits Today

Under the present benefit structure, when a worker applies for Social Security benefits, his or her earnings history is indexed by the growth in average wages. In this way earnings from years ago are adjusted to take account of subsequent increases in the general price level and subsequent increases in productivity, which reflect growth for the economy as a whole. The inflation adjustment is necessary to express real earnings and real contributions in all years in terms of dollars of the same real value. However, the productivity adjustment is simply a means of raising benefits. It is as if the System were assuming that workers were as productive 30, 20 and 10 years ago as they are today, and that their contributions into the System had been correspondingly higher.

From the wage-indexed earnings history an average indexed monthly earnings figure (AIME) is derived. The primary insurance amount (PIA), or basic benefit, is computed as follows:

PIA = 90 percent of the first $230 of the AIME, plus
32 percent of the AIME between $230 through $1,388, plus
15 percent of the AIME over $1,388.

The bend points, $230 and $1,388, are also increased each year by the growth in wages. It is this wage-indexing of the earnings history and the bend points which keeps the basic retirement benefit constant as a share of pre-retirement earnings for each retiring cohort. Because real wages grow over time, real Social Security benefits will continually increase over time.

Note that the benefit formula has three brackets, somewhat analogous to brackets in the income tax, with replacement rates (rather than tax rates) of 90 percent, 32 percent and 15 percent. If the bend points (brackets) were not adjusted over time, rising wages, whether due to inflation or real income growth, would produce rising AIMEs which would spill over increasingly into the 15 percent replacement rate bracket. As more of the AIME fell into a lower replacement rate bracket, the replacement rate would fall over time. With real income growth, the falling replacement rate would still mean rising real benefits although the rate of increase would slow. However, inflation-induced income growth would mean lower real benefits. This is similar to the way both real income gains and inflation raise real tax liabilities under our unindexed income tax; whether a worker receives an increase in real income or only a cost-of-living increase, he is pushed into a higher bracket.

Of course, there is an alternative to wage-indexing the bend points. If the bend points were adjusted by prices, as the brackets in the income tax will be after 1985, the real initial benefit would be protected from inflation. Increases in the AIME due solely to inflation would be matched by growth of the bend points. The inflation-induced increase in income would not cause the AIME to spill further into the lower replacement brackets. However, real wage increases, which would cause the AIME to rise faster than the bend points, would cause the AIME to fall into the lower replacement rate brackets. Real benefits would still rise but more slowly than real wages.

On the other hand, wage-indexing the bend points keeps real benefits rising in proportion to wages. Neither inflation nor real wage growth forces the AIME into a lower replacement rate bracket. This is more generous treatment than taxpayers will receive under indexation of the income tax, where a real wage increase will still force a taxpayer into a higher tax bracket.

APPENDIX B

To flesh out this solution, there are a number of tables which must be obtained on an updated basis from the Social Security Administration. They should be based on the 1983 Trustees' report, and cover the intermediate Alternative II-B assumptions at a minimum, and the Alternative II-A assumptions if possible.

A. Analogous to Table 2, attached: Projected OASDI primary insurance amounts for low, average and high income single workers retiring between 1985 and 2060, displayed in real 1983 dollars (deflated by the CPI). Annual figures are not needed. Every fifth year would be adequate.

B. Analogous to Table 3, attached: Growth in primary insurance amounts for low, average and high income single workers retiring between 1985 and 2060 under price-indexing of the bend points beginning in 1985, displayed in real 1983 dollars as above. The Council may also wish to see figures for price-indexing beginning in 1990.

C. Analogous to Table 4, attached: Effect of savings from price-indexing bend points of the benefit formula. Cost rates as a percent of payroll under wage- and price-indexing should be displayed, as well as the remaining deficits, for both OASDI and OASDHI. Starting dates of 1985 and 1990 should be examined.

D. Similar to B, but providing for the price-indexing of both the bend points and the earnings history beginning in 1985. Conversion to price-indexation of earnings histories should be gradual (e.g., for a worker retiring in 2000, his earnings in the 1985-2000 period should be completely price-indexed. For a year prior to 1985, such as 1980, the earnings should be wage-indexed through 1984 and price-indexed 1985 to 2000). Figures for a 1990 starting date should also be examined.

E. Similar to C, but providing for price-indexing of both the bend points and the earnings history, showing both 1985 and 1990 starting dates.

STATEMENT OF MR. JAMES A. LEBENTHAL, CHAIRMAN OF THE BOARD, LEBENTHAL AND CO., INC., NEW YORK, N.Y.

Senator ARMSTRONG. Mr. Lebenthal, would you proceed please?

Mr. LEBENTHAL. Thank you, Mr. Chairman.

My name is James Lebenthal. I am the chairman of the New York municipal bond firm of Lebenthal and Co., founded in 1925 by my father and mother to deal exclusively in municipal bonds for the individual investor. Now I might say Dad is gone. Mother still, at 84, comes down to the office. Was down at 8:20 this morning, and when we last checked at 5, she was still there—so there is someone to match your own forbearance and patience in this long, long day—so that I could be here today to represent the Public Securities Association, the municipal bond trade association, in our deeply felt support for Senate bill 1113 to remove tax municipal bond interests from the formula for computing the social security tax.

Now it is our feeling that the inclusion of municipal bond income in adjusted gross income to get at a component of adjusted gross income is a tax on the municipal bond itself. And as such, would be unconstitutional. The constitutional issue aside, now is not the time when our cities and States are being asked to take on the financial responsibility for rebuilding America to tamper with the economic incentive that people have for investing in municipal bonds. But aside from pulling the rug out from under the bonds of our American cities and States, using municipal bond interest in determining the threshold for taxing social security income hits this one class of citizens below the belt—the retired and elderly who when they bought their bonds never envisioned that the income that they derived from those bonds might reduce their social security benefits.

The way municipal bond income or exemption has always been worded, going back to the original Revenue Act of 1913, is as follows:

> Interest from obligations of the state territory or any political subdivision thereof is wholly exempt, excluded from gross income.

The new law for the very first time includes municipal bond interest in adjusted gross income. Now that is some about face in the relations between the States and the Federal Government. And it's totally inconsistent with the sensitivity that Congress has always manifested when the exemption of Federal securities from State taxation has been at stake. And what concerns us at PSA is how Congress on the one hand has taken this back door approach to taxing municipal bonds, and on the other hand has always been Johnny on the spot protecting the immunity of Federal obligations from State interference.

Now I will give you an example. In 1948, my wife's home State of Idaho enacted a tax on every individual measured by net income. Now contrary to Federal Revenue Statute 3701, Idaho included in its computation of net income the interest from Federal obligations, taking the position—"We are not taxing the income from the Federal obligations. We are taxing the individual."

Congress saw through that. And amended 3701 to prohibit every form of direct and indirect taxation on Federal obligations, with the exception of franchise, estate, and inheritance taxes.

For the Federal Government to now turn around and tax municipal bond interests is to miss the whole point of tax exemption in the first place, which is reciprocity.

This reciprocity is destroyed if the Congress does one thing to protect Federal securities and then goes off in a different direction and mandates that municipal bonds must be taken into consideration in taxing social security benefits.

Now someone argued that this is not a tax on municipal bonds. It's only a measurement of the tax on something else. In this case, social security benefits. After all, we do have State franchise taxes. We do have Federal inheritance taxes that use the other exempt securities as the measurement of the taxes due. In every case where the immunity from intergovernmental taxation has seemingly been breached, there has been a decided logical distinction between the ownership interest and the securities being taken into consideration, and an activity that is actually the object of the tax.

Here the distinction is one of words and not substance because in arriving at the threshold of taxability—I would say I have about another 60 seconds. May I proceed?

Senator ARMSTRONG. Go right ahead.

Mr. LEBENTHAL. In arriving at this threshold of taxability, what happens? One-half social security income, plus taxable income, plus tax-exempt municipal bond interest—they all go into one pot, and the part that boils over or spills over gets taxed. The object of the tax and the measurement of the tax are one in the same. What we have here is an Idaho spud in the petunia patch. What we have is a foot in the door that inevitably leads to the question—I think this is the important point—how may the bonds be taxed next? Because if Government can toy with the tax status of the bonds lightly, it can alter their status heavily. It's a signal to the bondholder that the bonds are not safe from removal of tax exemption in entirety.

Whatever the market impact, whether it's $590 million a year or $299 million, any increased cost for borrowing will be borne by everybody in his or her capacity as a local taxpayer.

I say, as the Public Securities Association says, that a tax that is so unfair, does so much mischief, and in practicality raises so little cold cash in paying obeisance to the illusion of equity and fairness and honest face is a bum deal.

We urge this committee to do nothing more for the bonds of our American cities and States than the Congress has already done for U.S. Government obligations: protecting them from the same kind of interference from the States. We urge you to support Senate bill 1113, and beyond that to give it your blessing.

Senator ARMSTRONG. Thank you very much. A very good statement. We appreciate it. We will be back to you in a moment.

[The prepared statement of Mr. Lebenthal follows:]

STATEMENT OF
JAMES A. LEBENTHAL
ON BEHALF OF
THE PUBLIC SECURITIES ASSOCIATION

Introduction

My name is James A. Lebenthal. I am the Chairman of the New York Municipal Bond firm Lebenthal & Co., Inc., founded in 1925 by my father—and mother—to deal exclusively in tax-free Municipal Bonds for the individual investor who now accounts for 80% of bond purchases.. Dad is gone. Mother carries on, still comes to the office—from 8 AM this morning to who knows when she'll leave today, so I could come down here and represent the Public Securities Association*, the Municipal Bond industry's trade organization, in our deeply felt support for S. 1113, Senator D'Amato's bill to remove tax free Municipal Bond interest from the formula for computing the social security tax.

Our Position

The inclusion of Municipal Bond income in adjusted gross income to get at a component of adjusted gross income is—a tax on the Municipal Bond itself, and, as such, would be unconstitutional. The constitutional issue aside, it's a drastic new step in intergovernmental affairs. And it is poor public policy. Our states are being asked to take on the financial responsibility for rebuilding of America. This is no time to tamper with the economic incentive people have for investing in Municipal Bonds. But aside from pulling the rug out from under the bonds of our cities and states, using Municipal Bond interest income in determining the threshold for taxing social security income hits one class of citizen below the belt—the retired and elderly who invested in Municipal Bonds, never contemplating that their pensions could be reduced by the amount of tax-free interest they receive.

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*PSA represents brokers, dealers, and dealer banks active in the municipal market, U.S. Government and federal agencies securities market, and the mortgage-backed seucirites market. We currently have nearly 300 member firms whose offices are located in all 50 states. Last year, our members participated in over 95 percent of the dollar volume of new issues of state and local government securities.

An Obsession With Forbidden Fruit

The tantalizing aroma of tax free Municipal Bond has always wafted under the nose of Treasury and beckoned like apple pie cooling on the window sill. But the obsession with this forbidden fruit really got going with the Tax Reform bill of 1969. On again, off again, ever since, it has been the minimum tax, the allocation of deductions tax, the limited tax preference tax, get those fat cats and Park Avenue millionaires. Where every previous attempt to tax those bonds has struck out, Section 121 of the Social Security Amendments of 1983 may have hit a home run. Something that looks like a federal tax on Municipal Bonds, that feels like a tax, that is a tax on Municipal Bonds is on the books, and for the first time is law of the land.

The Constitutional Question

In the few minutes we have, there is no need to rehash the constitutional basis for the immunity of federal obligations from taxation by the states and the reciprocal immunity of state and local bonds from taxation by the federal government. That litany has been recited to a faretheewell before the Senate Finance Committee every time this business of taxing Municipal Bonds comes up. In fact, in our prepared statement we have resubmitted the blow by blow account of tax exemption through the ages that was first submitted by the law firm Hawkins, Delafield & Wood to the Senate Finance Committee in 1969 during the committee's deliberations on the Tax Reform Bill of 1969.

About Face

The way Municipal Bond exemption is worded, going back to the first Revenue Act of 1913, is this: "Interest upon obligations of a state, territory, or any political subdivision thereof is wholly exempt (excluded from gross income.)"

The way the offending provision in Section 121 of the Social Security Amendments of 1983 is worded, adjusted gross income is modified to mean "adjusted gross income increased by the amount of interest received or accrued by the taxpayer, during the taxable year, which is exempt from tax." That is some about face in the relations between the states and the federal government and is totally inconsistent with the sensitivity Congress has manifested when the exemption of federal securities from state taxation has been at stake.

What concerns us is how Congress on the one hand has taken this backdoor approach to taxing Municipal Bonds and on the other hand has been Johnny-On-The-Spot protecting the immunity of federal obligations from state interference.

I'll give you an example.

Federal Exemption—Reciprocity Applied

In 1948, my wife's home State of Idaho enacted a tax on every individual measured by net income. At that time, federal law (Rev. Stat 3701) provided that "obligations of the United States shall be exempt from taxation by or under State or municipal or local authority." By golly, if Idaho didn't include in its computation of net income the interest from federal obligations, taking the position, "we're not taxing the income from the federal obligations, we're taxing the individual. Income is merely a measure..."

Congress saw through that, and amended 3701 by adding a second sentence that couldn't be in plainer English. "This exemption extends to every form of taxation that would require that either the obligations or the interest thereof, or both, be considered directly or indirectly, in the computation of the tax with the exception of...nondiscriminatory franchise...taxes..estate or inheritance taxes."

And only last month, the Supreme Court in American Bank and Trust Co. v.Dallas Co. upheld the plain talk of 3701 as amended and invalidated a state tax on bank shares that had failed to reduce the value of the shares by the portion of the bank's capital invested in federal obligations.

For the federal government now to turn around and tax Municipal Bonds is being deaf, dumb, and blind to the whole reason for tax exemption in the first place, which is reciprocity.

State Exemption—Reciprocity Ignored

Under our Constitution, neither the federal government nor the states may destroy the sovereignty of the other. By the teaching of every Supreme Court decision, the exemption of federal obligations from taxation by the states and state obligations from taxation by the federal government are reciprocal immunities. And the maintenance of this reciprocity has always been thought to be a function of Congress and not just something you leave to the Courts.

Where's the reciprocity if the Congress does one thing to protect federal securities, and then goes off in different direction and mandates that Municipal Bonds must be taken into consideration in taxing social security benefits? Where's the balance in that?

"But It's Not A Tax On...It's A Measurement Of..."

Some would argue that this is not a tax on Municipal Bonds. Its only a measurement of the tax on something else, in this instance social security benefits. After all, we have state franchise taxes and federal inheritance taxes—that use the other's tax exempt securities as the measurement of the taxes due.

In every case where the immunity from intergovernmental taxation has seemingly been breached, there has been a decided, logical distinction between the ownership interest in the securities being taken into consideration and the activity that is actually the object of the tax. A franchise tax is a tax on the exercise of the privilege of doing business. An inheritance tax is a tax on the activity of transferring property.

Yes, a tax may be measured by income even if part of such income is derived from immune sources, if there is a distinction of substance between what is being measured and what is being taxed.

A Distinction of Words Without Substance

But here the distinction is one of words, not substance. In arriving at the threshold of taxability, one half social security income plus taxable income plus tax exempt Municipal Bond interest all go into the one pot—and the part that boils over gets taxed. The object of the tax and the measurement of it are one and the same.

What we have is an Idaho spud in the petunia patch.

Cost Inefficient

We are told that the anticipated revenues to be raised by this provision are no more than $5 million over a seven year period, but the Municipal Finance Officer's Association estimated that the cost to our localities in increased borrowing costs could run anywhere from $299 million to $590 million a year. Who is to quantify the impact this tax on Municipal Bonds will eventually have on the marketplace? The additional burden to our local issuers will depend on how the tax is perceived, the publicity it gets, how we have to qualify "tax exemption" in sales literature in the interest of full disclosure. The trouble is the foot is in the door and the inevitable question is, "How may the bonds be taxed next?" which brings me to the issue of trust.

The Matter of "Trust"

In its operation, this isn't "soak the rich," it's a booby trap for the little old widow who saved all her life because she thought the bonds were safe and tax free. Now she finds out that in her old age her pension can be reduced by the amount she gets from her state bonds, which she never contemplated when she bought them.

It takes tremendous trust to put your life savings in the 30-year bonds of someplace you never heard of or have heard all too much about. Trust that you are going to get paid. Trust that the lesser return you have accepted because it's tax free will remain tax free during the life of the bond.

If government can toy with the tax status of the bonds lightly, it can alter their tax status heavily. It's a signal to the bondholder that the bonds are not safe from removal of tax exemption in entirety. $299 million? $590 million? Whatever the market impact, any increased cost for borrowing will be borne by everybody—in his or her capacity as a local taxpayer.

A tax that is so unfair, does so much mischief and in practicality raises so little cold cash in paying obeisance to the illusion of equity and fairness is on its face a bum deal.

We urge this committee to do nothing more for the bonds of our great American cities and states than you have done for United States government obligations: support S. 1113 and give it your blessing.

STATEMENT OF HAWKINS, DELAFIELD & WOOD

67 Wall Street, New York, New York 10005

Re: PROPOSED TAX REFORM ACT OF 1969 (H. R. 13270)

Preliminary Statement

This statement is submitted in accordance with press release of the Senate Committee on Finance and a telegram from the Chief Counsel of the Committee received on September 10, 1969.

The principal points presented in the statement are summarized as follows:

(1) The minimum tax on income including state and municipal bond interest levied by the House Bill is unconstitutional. The *Pollock* case holds that a tax on the interest from state and municipal bonds is unconstitutional. The Sixteenth Amendment did not change the decision in the *Pollock* case. The Congress has construed the Sixteenth Amendment consistently with the decision in the *Pollock* case. The history of the adoption of the Sixteenth Amendment confirms the Congressional and Supreme Court construction of its intent and meaning. To the extent that the minimum tax applies to interest on local housing authority obligations it also impairs the obligation of contract.

(2) The withdrawal from state and municipal bondholders of deductions allowed other taxpayers discriminates against individuals owning tax-exempt securities and by raising the cost of borrowing interferes with the borrowing power of states and municipalities. Although Congress may in some circumstances disallow deductions directly related to interest on state and municipal bonds or properly allocable to such interest, by disallowing deductions not reasonably related to the receipt of tax-exempt income, the House Bill violates the doctrine enunciated in the *National Life Insurance Company* case and is not supported by the *Atlas Life Insurance Company* case.

(3) The municipal bond subsidy provisions and the provisions relating to arbitrage obligations of state and local governments provide for unnecessary and undesirable federal control of state and local financing. Neither industrial development bonds as defined in Section 107 of the Revenue and Expenditure Control Act of 1968 or arbitrage obligations would be eligible for the subsidy program. Thus many bonds which would be issued to finance facilities for many acknowledged and traditional state and local functions would be ineligible. In addition the subsidy program is unworkable in certain respects. No political subdivision of any state has the power at the present to issue taxable bonds notwithstanding the possible passage of the Tax Reform Act of 1969. The payment of a percentage of interest yield on taxable state and local obligations is of no value. The dual coupon concept will not accomplish its intended purpose because state interest limitations will nonetheless apply. The administration of the subsidy program will involve substantial and undesirable federal involvement in state and local financing.

I

The minimum tax on income including State and Municipal bond interest levied by the House Bill is unconstitutional.

Section 301(a) of the House Bill adds a new Section 84 to the Internal Revenue Code of 1954. The new section includes in the gross income of a taxpayer other than a corporation the amount of so-called "disallowed tax preferences" and defines the so-called "items of tax preference." Among the items is any excess of interest on obligations which is excludible from gross income under section 103 of the Code, namely, the interest on "the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia."

The proposed section provides a transitional rule for including interest exempt under section 103 as an item of tax preference which is 10% multiplied by the number of taxable years beginning after December 31, 1969. When the new section is fully effective the limit on tax preferences will be an amount equal to (1) one-half of the sum of the items of tax preference and the taxpayer's adjusted gross income or (2) $10,000, whichever is greater.

The Report of the Committee on Ways and Means illustrates the application of the limit on tax preferences by the case of a taxpayer with a salary of $50,000 and tax preference items amounting to $150,000 and states that:

> "Under present law, such an individual is taxed only on his $50,000 of salary. Under the limit on tax preferences, he is to be required to pay tax on $100,000 of income (one-half of his total income of $200,000)." H. Rep. No. 91-413 (Pt. 1) (91st Cong., 1st Sess.) p. 79.

Thus, if the tax preference item comprises only interest on hitherto tax-exempt securities and 100% of the interest is taken into account at the end of the transitional period, the individual who receives a $50,000 salary and $150,000 in interest on tax-exempt securities will pay a tax on $100,000 of income. Obviously, since his salary amounts to $50,000 the remaining income of $50,000 on which he pays a tax can not consist of any income other than the interest received on his state and municipal bonds.

Law, as Mr. Justice Holmes has told us, is a "prophecy of what courts do in fact." In our opinion, the Supreme Court would hold that such a tax on the interest on state and municipal bonds is unconstitutional for the reasons stated below. From the time the income tax was imposed in 1913 until now both Congress and the Supreme Court have adhered steadfastly to the constitutional doctrine that state and municipal bond interest is exempt from federal income tax. It would be strange for Congress to abdicate its obligation to respect constitutional limitations upon its power by levying a tax on such interest without awaiting new constitutional authorization.

The doctrine of federal immunity from state interference, including interference by taxation, is a general principle of constitutional law with which this Committee is undoubtedly familiar. The converse immunity of the states from federal interference is equally well established. The doctrine was specifically applied to interest on bonds of states and municipalities and of state and municipal instrumentalities by the Supreme Court of the United States in the landmark case of *Pollock* v. *Farmers' Loan & Trust Company,* 157 U. S. 429 (1895) and on rehearing, 158 U. S. 601 (1895).

The cases decided by the Supreme Court under the Sixteenth Amendment as well as the legislative history of the amendment in Congress during the period it was being ratified by the state legislatures demonstrate that any claim that the amendment repudiated the rule of the *Pollock* case is unsupported by any judicial precedent, is unfounded in fact, and altogether spurious.

For the purpose of this statement it is not necessary or desirable to delve into the much repeated history of the constitutional doctrine of reciprocal immunity before August 15, 1894 when Congress enacted a statute which levied a tax upon net income, including income from all real property and from all personal property, both tangible and intangible, including the interest on state and municipal bonds.

At that time and until the Sixteenth Amendment became effective on February 25, 1913, Article I, Section 2, of the federal Constitution required the apportionment of "direct taxes" among the states according to population, as follows:

> "Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective numbers, which shall be determined by adding to the whole Number of free Persons, including those bound for Service for a Term of Years, and excluding Indians not taxed, three-fifths of all other Persons."

Article I Section 8, of the Constitution also requires that "Duties, Imposts and Excises" shall be uniform, as follows:

> "The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States; . . . "

A. *The Pollock Case holds that a tax on the interest from State and municipal bonds is unconstitutional.*

In the *Pollock* decision which considered the validity of the income tax law of 1894, the Supreme Court pointed out that the federal government had an unlimited power of taxation with a single exception and subject to two qualifications. The one exception was that "Congress cannot tax exports . . . " The two qualifications were that Congress "must impose direct taxes by the rule of apportionment, and indirect taxes by the rule of uniformity." 157 U. S. at 557.

In the first *Pollock* case the Supreme Court held that a tax on the rents and other income from real estate was a direct tax and consequently violated the Constitution because the tax was not "apportioned among the several States . . . according to their respective numbers." The Court also unanimously held that the taxing power, like any and all other powers of the federal government, was impliedly subject to the constitutional limitation that it could not be so exercised that the instrumentalities of the states were taxed. 157 U. S. at 584.

Thus, the first decision in the *Pollock* case held the income tax act of 1894 invalid in respect of (1) the tax on rents and other income from real estate and (2) the tax on the interest from state and municipal bonds. The justices divided equally on the constitutionality of the income tax pertaining to personal property other than state and municipal bonds and on whether the 1894 act as a whole was unconstitutional.

On rehearing the Supreme Court decided (four of the justices dissenting) first, that the tax on income from personal property was a direct tax and hence was invalid because not apportioned and, second, that the 1894 Act was unconstitutional in its entirety.

The *Pollock* decision was unanimous as to municipal bond interest because in the words of Mr. Justice Fuller to tax the interest on municipal bonds "would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract,"* and would be a "tax on the power of the States and their instrumentalities to borrow money and consequently repugnant to the Constitution." 157 U. S. at 586.

To the same effect was the separate opinion of Mr. Justice Field:

> "These bonds and securities are as important to the performance of the duties of the State as like bonds and securities of the United States are important to the performance of their duties, and are as exempt from the taxation of the United States as the former are exempt from the taxation of the States." 157 U. S. at 601

And Mr. Justice Brown who had concluded that "a tax upon rents or income of real estate is a tax upon the land itself" nevertheless said in the second *Pollock* decision:

> "The tax upon the income of municipal bonds falls obviously within the other category, of an indirect tax upon something which Congress has no right to tax at all, and hence is invalid. Here is a question, not of the method of taxation, but of the power to subject the property to taxation in any form." 158 U. S. 692-693

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* This is a prophecy found to be all too accurate and greatly understated by those state and municipal officials who have tried to borrow money since the introduction of the bill. The Monthly Economic Letter of the First National City Bank of New York says "the damage done by the proposals in the bill in terms of raising the cost of borrowing by States and municipalities this year cannot be underestimated. Those governments which have been penalized this year have no recourse to a Treasury subsidy."

Thus, all the justices in both *Pollock* decisions, whether they subscribed to the theory that a tax on income was a tax on the source of the income or considered that theory untenable, came to the identical conclusion that the interest on state and municipal bonds could not be included in federally taxable income. It is clear, therefore, that the decision in *Pollock* concerning the unconstitutionality of taxing state and municipal bond interest rests not on the economic premise that a tax on income is a tax on the source of the income but on the inviolability of the borrowing power of the states and their political subdivisions.*

B. *The Sixteenth Amendment did not change the decision in the Pollock Case.*

This, then, was the law when the Sixteenth Amendment was declared in full force and effect by the Secretary of State on February 25, 1913. The Amendment reads:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

1. *The Congress has construed the Sixteenth Amendment consistently with the decision in the Pollock Case.*

Even before the Supreme Court decided that the phrase "from whatever source" in the Amendment relates not to the power to tax but to the requirement that certain federal taxes must be apportioned among the states according to their respective populations, Congress had also concluded that the object of the Amendment was to eliminate the necessity of *apportionment* irrespective of source in order that the income derived from the source of real and personal property could be taxed. Briefly stated, the Amendment means that a tax on income "from whatever source" is immune from the constitutional requirement of apportionment. 38 Stat. L. 168 (1913); 39 Stat. L. 758-59 (1916); 40 Stat. L. 329-30 (1917) and 1065-66 (1918).

When during World War I, a revenue act was drafted with a provision to include the interest on municipal bonds in gross income, the lack of power to tax such interest was expressed both in committee reports and congressional debate. It was recognized that lack of apportionment was not the objection to federal taxation of state and municipal bond interest but that the lack of power to tax such interest was absolute. The provision was omitted. H. Rep. No. 767, (65th Cong. 2nd Sess.) p. 9; Sen. R. No. 617, (65th Cong. 3rd Sess.) p. 6; 56 Cong. Rec. p. 10933-41, 10628-33, 11181-87.

Such a contemporaneous construction of the Sixteenth Amendment by Congress from the time it became effective through World War I is certainly an influential if not a controlling consideration in determining the meaning of the Amendment.

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* The reluctance of the four justices in both *Pollock* cases to accept the theory that a tax on income is a tax on the source of the income was later shared by the Supreme Court in *New York ex rel Cohn* v. *Graves*, 300 U. S. 308 (1937) in which the New York State income tax on rents from real estate in New Jersey was upheld. Obviously, however, this was not the *ratio decidendi* of the *Pollock* case, because four of the justices who did not agree that a tax on income from personal property was a tax on the property itself joined with the other justices in invalidating the tax on municipal bond interest.

Later, in 1923, after the decision of the Supreme Court in *Evans* v. *Gore,* 253 U. S. 245 (1920), to be discussed below, Congress considered and the House of Representatives passed a constitutional amendment* to authorize the taxation of income derived from future issues of state and municipal bonds and to authorize states to tax the income of future issues of federal bonds. H. J. Res. 314, (67th Cong. 4th Sess.); H. Rep. No. 969, (67th Cong. 2d Sess.) The proposal failed to pass the Senate.

2. *The Supreme Court has construed the Sixteenth Amendment consistently with the decision in the Pollock Case.*

In *Evans* v. *Gore,* 253 U. S. 245 (1920), the Supreme Court held (Justice Holmes and Brandeis dissenting) that the Sixteenth Amendment did not authorize an income tax on the salary of a federal judge in view of the fact that the Constitution provided that the compensation of judges "shall not be diminished during their continuance in office." Const. Art. III Sec. 1.

The Court then considered whether the constitutional inhibition against such diminution was modified by the Sixteenth Amendment. After an elaborate analysis of the Sixteenth Amendment the Court concluded that:

> "the genesis and words of the Amendment unite in showing that it does not extend the taxing power to new or excepted subjects, but merely removes all occasion otherwise existing for an apportionment among the States of taxes laid on income, whether derived from one source or another." 253 U. S. at 261-2.

Although *Evans* v. *Gore* was overruled in *O'Malley* v. *Woodrough,* 307 U. S. 277 (1939), it is clear from the opinion of Mr. Justice Frankfurter in the latter case that the decision that federal judges could be taxed on their salaries was based on the premise that, as Justices Holmes and Brandeis had said in their dissenting opinion in *Evans* v. *Gore,* a tax on salaries was not a diminution of compensation. Only that portion of the majority opinion in *Evans* v. *Gore* was repudiated and not one word in the opinion in *O'Malley* v. *Woodrough* questions the above-quoted conclusion of the Court in *Evans* v. *Gore* concerning the Sixteenth Amendment.

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* The proposed amendment read as follows:

"[H. J. Res. 314, Sixty-seventh Congress, fourth session.]

JOINT RESOLUTION Proposing an amendment to the Constitution of the United States.

Resolved by the Senate and House of Representatives of the United States of America in Congress assembled (two-thirds of each House concurring therein), That the following article is proposed as an amendment to the Constitution of the United States, which shall be valid to all intents and purposes as part of the Constitution when ratified by the legislatures of three-fourths of the several States:

'ARTICLE .

'SECTION 1. The United States shall have power to lay and collect taxes on income derived from securities issued, after the ratification of this article, by or under the authority of any State, but without discrimination against income derived from such securities and in favor of income derived from securities issued, after the ratification of this article, by or under the authority of the United States or any other State.

'SEC. 2. Each State shall have power to lay and collect taxes on income derived by its residents from securities issued, after the ratification of this article, by or under the authority of the United States, but without discrimination against income derived from such securities and in favor of income derived from securities issued after the ratification of this article, by or under the authority of such State.'"

In *Evans* v. *Gore* the Supreme Court had referred to previous cases in which the Court had considered the Sixteenth Amendment, beginning with the opinion of Chief Justice White in *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1 (1916) which was the first case involving the scope and meaning of the Sixteenth Amendment. In that case, referring to the text of the Amendment the Chief Justice had declared (240 U. S. at 17-18):

> ". . . It is clear on the face of this text that it does not purport to confer power to levy income taxes in a generic sense—an authority already possessed and never questioned—or to limit and distinguish between one kind of income taxes and another, but that the whole purpose of the Amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived. Indeed, in the light of the history which we have given and of the decision in the *Pollock Case* and the ground upon which the ruling in that case was based, there is no escape from the conclusion that the Amendment was drawn for the purpose of doing away for the future with the principle upon which the *Pollock Case* was decided, that is, of determining whether a tax on income was direct not by a consideration of the burden placed on the taxed income upon which it directly operated, but by taking into view the burden which resulted on the property from which the income was derived, since in express terms the Amendment provides that income taxes, from whatever source the income may be derived, shall not be subject to the regulation of apportionment."

The *Brushaber* case was decided on January 24, 1916. On Feberuary 21, 1916, the Supreme Court handed down the decision in *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103 (1916). The decision was unanimous and again the Court reiterated the rule

> ". . . that the provisions of the Sixteenth Amendment conferred no new power of taxation . . ." 240 U. S. at 112

In *Peck & Co.* v. *Lowe*, 247 U. S. 165 (1918), the Supreme Court decided that the net income of a corporation derived from exporting goods was not a tax on exports prohibited by the Constitution, the unanimous opinion of the Court stating:

> "The sixteenth amendment, although referred to in argument, has no real bearing and may be put out of view. As pointed out in recent decisions, it does not extend the taxing power to new or excepted subjects, but merely removes all occasion, which otherwise might exist, for an apportionment among the States of taxes laid on income, whether it be derived from one source or another." 247 U. S. at 172-3

Two years later, in *Eisner* v. *Macomber*, 252 U. S. 189, 206 (1920), the Court said:

> "As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which might otherwise exist for an apportionment among the States of taxes laid on income."

In 1926 in *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, 521, Mr. Justice Stone flatly declared:

> ". . . the sixteenth amendment did not extend the taxing power to any new class of subjects."

Five years later, in *Willcuts* v. *Bunn*, Chief Justice Hughes, 282 U. S. 216, 226 (1931), speaking for a unanimous Court which held capital gains on the sale of public securities to be taxable, reiterated the rationale of the rule as follows:

> "In the case of the obligations of a State or of its political subdivisions, the subject held to be exempt from Federal taxation is the principal and interest of the obligations. *Pollock* v. *Farmers' Loan & Trust Company, supra.* These obligations constitute the contract made by the State, or by its political agency pursuant to its authority, and a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of the Government."

Again in *James* v. *Dravo Contracting Co.*, 302 U. S. 134, 153 (1937) Chief Justice Hughes restated the reason for income tax immunity of state and municipal bond interest as follows:

> "There is no ineluctable logic which makes the doctrine of immunity with respect to government bonds applicable to the earnings of an independent contractor rendering services to the Government. That doctrine recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' *(Pollock* v. *Farmers Loan & Trust Co., supra)* and which would directly affect the Government's obligations as a continuing security. *Vital considerations are there involved respecting the permanent relations of the Government to investors in its securities and its ability to maintain its credit,—considerations which are not found in connection with contracts made from time to time for the services of independent contractors."* (italics supplied)

And again, in *Helvering* v. *Mountain Producers Corporation*, 303 U. S. 376, 386 (1938) the Chief Justice repeated that:

> "a tax on the interest payable on state and municipal bonds has been held to be invalid as a tax bearing directly upon the exercise of the borrowing power of the Government (*Weston* v. *Charleston* * * *, *Pollock* v. *Farmers' Loan & Trust Co.* * * *)."

In the previous year Mr. Justice Cardozo had also pointed out in *Hale* v. *Iowa State Board*, 302 U. S. 95, 107 (1937):

> "By the teaching of the same *(Pollock)* case an income tax, if made to cover the interest on Government bonds, is a clog upon the borrowing power such as was condemned in *McCulloch* v. *Maryland* * * * and *Collector* v. *Day* * * *."

And in *Helvering* v. *Gerhardt,* 304 U. S. 405 (1938), in upholding a federal income tax as applied to salaries of the employees of the Port Authority, Chief Justice Stone also referred to the hazard of impairing the borrowing power, stating that the immunity doctrine had been sustained

> "where * * * the function involved was one thought to be essential to the maintenance of a state government: as where the attempt was * * * to tax income received by a private investor from state bonds, and thus threaten impairment of the borrowing power of the state, *Pollock* v. *Farmers' Loan & Trust Company,* 157 U. S. 429; cf. *Weston* v. *Charleston, supra,* 465-466."

The rationale of the *Helvering* v. *Gerhardt* case was followed in *Graves* v. *New York ex rel O'Keefe,* 306 U. S. 466 (1939) in which the Court held that the salary of an employee of the Home Owners Loan Corporation was not immune from state income tax. Both these cases relate to the same question whether intergovernmental immunities extend to the salaries of employees: *Gerhardt* to a federal income tax applicable to state employees and *O'Keefe* to a state income tax applicable to federal employees.

It is noteworthy that in the *Gerhardt* case Mr. Justice Stone pointed out that the *Pollock* case had no application because, as distinguished from the income taxation of public salaries, the income taxation of public securities would "threaten impairment of the borrowing power of the state." The *O'Keefe* case does not refer to the *Pollock* case, probably because of the Government's position that the income taxation of public securities was essentially different.

In his argument in *Graves* v. *O'Keefe* before the Supreme Court, Solicitor General Robert Jackson, later Justice of the Supreme Court, had explained that the Government accepted the distinction drawn by Chief Justice Stone in the *Gerhardt* case and had emphasized that where one deals with a debtor-creditor relationship, the borrower is the one who is burdened. The Solicitor General said that it was *the presence of an actual burden upon the public instrumentality which issues public securities which distinguished the taxation of the interest on public securities from the taxation of the salaries of public employees.*

The evidence is overwhelming that the views of Congress and the Supreme Court on the scope of the Sixteenth Amendment correctly express the purpose and meaning of the Amendment. That purpose was to permit Congress to levy and assess taxes on income without complying with the impracticable rule of apportionment according to population. Before the Amendment Congress had the power to lay income taxes but not without apportionment. After the Amendment Congress need not apportion. The history of the Amendment proves that it was never intended to repeal the constitutional doctrine of reciprocal immunity from taxation of state and federal instrumentalities and obligations.

3. *The history of the adoption of the Sixteenth Amendment confirms the Congressional and Supreme Court construction of its intent and meaning.*

Sixty years ago President Taft sent a special message to Congress in which he urged a constitutional amendment which would confer upon the national government

> "the power to levy an income tax * * * without apportionment among the states in proportion to population."

The President urged Congress not to reenact the 1894 income tax law which had been declared unconstitutional, saying:

> "For the Congress to assume that the court will reverse itself, and to enact legislation on such an assumption, will not strengthen popular confidence in the stability of judicial construction of the Constitution." 44 Cong. Rec. (June 16, 1909) p. 3344

Previous to President Taft's special message, Senator Brown of Nebraska had offered a resolution for a constitutional amendment to the effect that "The Congress shall have power to lay and collect taxes on incomes and inheritances." Upon being informed in debate that Congress already had both of the powers in question and that only the rule of apportionment stood in the way of federal income taxation, Senator Brown offered, a few days later, a second resolution which read that "The Congress shall have power to lay and collect direct taxes on incomes without apportionment among the several states according to population." 44 Cong. Rec. pp. 1548, 1568-9, 3377. The Senate Finance Committee soon reported a resolution for a constitutional amendment in which the words "direct taxes" were changed to "taxes" and after "income" the words "from whatever source derived" were inserted. The proposed amendment then read:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." 44 Cong. Rec. p. 3900

The Committee gave no explanation of the reason for these changes.* However, the reason for the two changes is clear. The words "direct taxes" in Senator Brown's proposal would require explanation because it was not obvious why the amendment should only provide that direct taxes need not be apportioned. Hence, to eliminate the ambiguity of "direct taxes" the committee provided that taxes on income "from whatever source derived" need not be apportioned. Senator Brown's proposed amendment as clarified by the Senate Finance Committee did not grant power to Congress to lay and collect a tax on incomes; Congress already had plenary power to levy income taxes under Article I, Section 8 of the Constitution (quoted *supra* at p. 3). The phrase "from whatever source derived" was simply another way of saying that Congress need no longer apportion any tax on incomes, irrespective of the source of the income; that was the sole purpose of the Amendment proposed by President Taft and introduced by Senator Brown.

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* The only colloquy which took place when the revised resolution was reported to the Senate is found in 44 Cong. Rec. 3900.

The debate in Congress took one day in the Senate and one day in the House. The joint resolution proposing the amendment as redrafted by the Committee passed both houses and was immediately submitted to the states. No consideration was given at all to the question of the taxation of income from state and muncipal bonds. The matter simply was not discussed. There was no indication that anyone sought to overturn the doctrine that state and municipal bond interest was immune from federal taxation which had been unanimously established in the *Pollock* case.

On January 5, 1910, Governor Hughes of New York submitted the amendment to the Legislature with a message calling attention to the words "from whatever source derived," suggesting that this might permit the taxation of income from state and municipal bonds, and questioning whether the amendment should be ratified.

On February 10, 1910, Senator Borah spoke in the Senate in answer to Governor Hughes' objection, stating in substance that no such meaning could be attached to the amendment. 45 Cong. Rec. 1694-9. He was followed by Senator Brown who concurred with Senator Borah's interpretation. Later, Senator Brown pointedly suggested that Governor Hughes stood alone in his fear:

> "It is a very significant fact that this amendment which was pending in Congress for days and was the subject of discussion by Congress and the press, should never have met this criticism while it was pending. In its present form it had the support of a unanimous Senate and a practically unanimous House of Representatives, who were all, judged by their votes, in favor of conferring this power on Congress, and yet no one in Congress ever suggested any change in the language of the resolution or proposed an amendment thereto to cover the objection now made.
>
> "Nor did any distinguished Governor from any of the 46 States, all of whom are now very loud in their protestations that the Government should have the power to tax incomes without apportionment, ever suggest that the amendment should have been modified in form in any respect. In this body the State of New York enjoys representation of the very highest character and most eminent ability, and yet New York on the roll call, as shown in the Congressional Record, was in favor of this amendment as it passed Congress, and was silent as to any suggestion that the language was faulty.
>
> * * *
>
> "The amendment does not alter or modify the relation today existing between the States and the Federal Government. That relation will remain the same under the amendment as it is today without the amendment. It is conceded by all that the Government cannot under the present Constitution tax state securities or state instrumentalities." 45 Cong. Rec. 2245-6 (Feb. 23, 1910)

On February 17, 1910, Senator Elihu Root of New York, a strong advocate for the amendment, wrote to New York State Senator Davenport giving his reasoned opinion that the amendment did not affect the immunity of state and municipal bonds. Senator Root wrote:

> "Much as I respect the opinion of the Governor of the State, I cannot agree with the view expressed in his special message on January 5, and as I advocated in the Senate the resolution to submit the proposed amendment, it seems appropriate that I should state my view of its effect.
>
> * * *
>
> "The proposal followed the suggestion of the Supreme Court in the *Pollock case.*
>
> "The evil to be remedied was avowedly and manifestly the incapacity of the National Government resulting from the decision that income practically could not be taxed when derived either from real estate or from personal property, although it could be taxed when derived from business or occupation.
>
> "The terms of the amendment are apt to cure that evil and to take away from the different classes of income considered by the court a practical immunity from taxation based upon the source from which they were derived." 45 Cong. Rec. p. 2539-40 (Mar. 1, 1910)

Thus, three United States Senators sought to allay any doubt held by Governor Hughes. No other member of Congress or any Governor* expressed any other view. That Governor Hughes' doubts were set at rest is shown by his opinions after he became Chief Justice, in *Willcuts* v. *Bunn* (*supra*, p. 8), *James* v. *Dravo Contracting Co.* (*supra,* p. 8) and *Helvering* v. *Mountain Producers Corporation* (*supra,* p. 8).

No one would doubt that if the states and their municipalities were to attempt to impose state or local taxes upon interest received by their residents from obligations of the Federal government, such a levy would be unconstitutional in the absence of consent by Congress to such taxation. *Weston* v. *City of Charleston,* 2 Pet. (U. S.) 449 (1829). And this is so even though it is universally accepted that the state legislatures possess plenary power to tax, subject only to the limitations of their state constitutions.

It is our opinion that the unanimous holding in the *Pollock* case, reaffirmed so many times after the Sixteenth Amendment, that interest on state and municipal securities is free from Federal income taxation under the Constitution would be again reaffirmed by the Supreme Court and that therefore the House Bill insofar as it seeks to lay a minimum tax applicable to such interest is unconstitutional.

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* In a message to the New Jersey Legislature, dated February 7, 1910, John Franklin Fort, Governor of New Jersey, said:

> "* * * Nor am I inclined to accept the statement that the Supreme Court of the United States might construe the words 'from whatever source derived' as found in the pending amendment as justifying the taxing of the securities of any other taxing power."

On February 23, Senator Brown, referring to the message of Governor Fort, of New Jersey, said:

> "It cheers our hearts to read in the press that President Taft agrees with the Governor of New Jersey, who, in a message to his legislature February 7 and since the New York message was transmitted, took immediate and direct issue with the governor of New York." [45 Cong. Rec., p. 2245]

C. *To the extent the minimum tax applies to interest on local housing authority and agency obligations it is also unconstitutional under the Fifth Amendment.*

It is also our opinion that if the minimum tax in the House Bill applies to the interest on bonds of local public housing authorities issued to finance low rent housing, slum clearance and urban renewal projects, the bill violates the Fifth Amendment to the Constitution.

The United States Housing Act of 1937 [50 Stat. L. 888] provides in section 5(e) as follows:

> "Obligations, including interest thereon, issued by public housing agencies in connection with low-rent housing or slum-clearance projects, and the income derived by such agencies from such projects, shall be exempt from all taxation now or hereafter imposed by the United States."

The Housing Act of 1949 [63 Stat. L. 413] provides in section 102(g) as follows:

> "Obligations, including interest thereon, issued by local public agencies for projects assisted pursuant to this title, and income derived by such agencies from such projects, shall be exempt from all taxation now or hereafter imposed by the United States."

Since the interest on obligations issued by a local public housing authority or agency constitutes interest upon obligations of a political subdivision of a state, such interest is excluded from gross income under section 103 of the Internal Revenue Code. When interest is excluded from gross income under the Code, the provisions of the House Bill imposing the minimum tax become operative and apply to such exempt interest in excess of the $10,000 floor.

Each of the above-quoted provisions of the United States Housing Act of 1937 and the Housing Act of 1949 that the obligations of local housing authorities and agencies "including interest thereon" * * * shall be exempt from all taxation now or hereafter imposed by the United States constitutes a statutory contract between the federal government and the holders of such obligations. In our opinion, to deprive such holders to any extent of their immunity from federal taxation on the interest which they receive from such obligations impairs the obligation of the contract in violation of the Fifth Amendment which "protects rights against the United States arising out of a contract." *Lynch* v. *United States,* 292 U. S. 571 (1933). See also *Farmers and Mechanics Savings Bank* v. *Minnesota,* 232 U. S. 516, 528 (1913).

II

ADR by arbitrarily disallowing deductions unrelated to tax-exempt interest discriminates against state and municipal bondholders.

Section 302(a) of the House Bill which adds a new section 277 to the Code is inconsistent with established principles of judicial decisions concerning income tax deductions. The new section provides in effect that if a taxpayer other than a corporation has so-called "allocable expenses" for a taxable year, the deductions otherwise allowable for such expenses are disallowed to the extent of an amount equal to (1) the aggregate of such expenses multiplied by a fraction, the numerator of which is the "allowable tax preferences" and the denominator of which is such preferences plus "modified adjusted" gross income, or (2) the "allowable tax preferences," whichever is lesser.

The deductions which the bill requires to be allocated are payments or losses not related to a business or to a transaction entered into for profit, including interest, state and local taxes, and personal theft and casualty losses, as well as charitable contributions, cooperative housing expenses, medical and dental expenses, and net operating losses attributable to nonbusiness casualty losses.

Among the "allowable tax preferences" which would cause the partial disallowance of allocable deductions is interest in excess of $10,000 received from state and municipal bonds issued on and after July 12, 1969.

The Secretary of the Treasury when he appeared before this Committee advocated the adoption of an even more stringent provision limiting deductions for individuals so far as interest on state and municipal obligations is concerned. Although the House Bill contains transitional provisions under which the interest on state and municipal bonds would be taken into account gradually over a ten-year transitional period, the Secretary of the Treasury proposed that 100% of the interest should be taken into account immediately. The respected Secretary referred to the section disallowing deductions as the "ADR" provision of the bill, meaning "Allocation of Deductions Rule."

The House Ways and Means Committee Report, which accompanied the bill, tries to give a simple example of the operation of sections 301 and 302 in a footnote which reads as follows:

> "For example, suppose the individual has as taxable income of $30,000, a tax-exempt income of $70,000, and $30,000 of personal deductions. Applying the limit on tax preference first results in adding $20,000 to the individual's taxable income increasing the latter to $50,000 and decreasing tax-free income to $50,000. Deductions are then allocated on the basis of a 50-50 split between taxable and nontaxable income, resulting in disallowing $15,000 of the total of $30,000 of deductions. For simplicity, this example omits the effect of the $10,000 floor." H. Rep. No. 91-413 (Part I), *supra*, p. 83, n. 3.

If, for example, the $30,000 of personal deductions consisted of contributions to charitable organizations (irrespective of whether the contributions consisted of cash or securities appreciated in value), the result would be that a substantial portion of the charitable contributions would be lost as a deduction.

First of all, the percentage limitation of 50% under the bill in the case of a cash contribution and 30% under the bill in case the contribution consisted of appreciated securities, would apply. Then the amount allowable as a deduction would be cut by 50% regardless of the nature of the charitable contribution. Presumably under the House Bill the amount in excess of the percentage limitation (either $5,000 if the contribution were in cash or $15,000 if the contribution were in appreciated securities) could be carried over for the following five years and deducted as a charitable contribution. Nevertheless the 50% disallowed as a result of the application of the proposed allocation of deductions rule could not be carried forward and the donor would have no tax benefit from having given this amount.

Omitting "for simplicity" the $10,000 floor, if the $30,000 of personal deductions consisted of state and local taxes, or casualty losses, instead of charitable contributions, one-half of the deductions would be disallowed.

A. *There is no doubt Congress may disallow deductions directly related to interest on state and municipal bonds or properly allocable to such interest.*

In order to clarify an issue already beclouded by a fundamental discrepancy between the bill and the Committee Report, we wish to emphasize that in our view, Congress has plenary power to disallow any deduction directly related to tax-exempt interest on state and municipal bonds. This principle is illustrated by the provision of the Revenue Act of 1921 [now Code § 265(2)] which forbids the deduction of interest paid on loans used to carry tax-exempt securities. In ***Denman* v. *Slayton*,** 282 U. S. 514 (1931) the constitutionality of this disallowance was upheld by a unanimous Supreme Court. The Court distinguished *National Insurance Company* v. *United States*, 277 U. S. 508 (1928) on the ground that Slayton, a municipal bond dealer, was not required to pay more taxes because he owned exempt securities.

Nor do we have any doubt regarding the constitutionality of section 265(1) of the Code which provides that no deduction shall be allowed for any

> "amount otherwise allowable as a deduction under section 212 (relating to expenses for production of income) which is allocable to interest * * * wholly exempt from taxes * * *."

For example, if an individual taxpayer receives one-half of his income from tax-exempt securities and one-half his income from taxable securities, all such securities being in a custody account of a bank, the custodian fees paid to the bank can constitutionally be allocated between the income from the tax-exempt securities and from the taxable securities. The statutory inhibition against the deduction of one-half of those fees and expenses is in our opinion constitutional because there is a meaningful basis for the allocation.

B. *By disallowing deductions not reasonably related to the receipt of tax-exempt income, ADR violates the rule of law in the National Life Insurance Company case.*

The House Ways and Means Committee Report gives lip service to the principle that allocation should be required "only for those expenses which can reasonably be assumed to be met in part out of tax-free income." H. Rep. 91-413 (Part 1), p. 82.

However, this assertion in the Committee Report finds no counterpart or expression in the House Bill which contains no clause confining the ADR to deductions having a reasonable relationship to the tax-exempt income.

Any attempt to include such a limitation on ADR would indeed be contradictory of the other provisions of the bill which apply ADR even when the deductions are wholly unrelated to the receipt of interest on state and municipal securities, such as, for example, the inclusion in so-called "allocable deductions" of casualty losses, charitable contributions, or state and local taxes.

Under ADR an individual with tax-exempt securities who also has deductions for casualty losses, charitable contributions or state and local taxes will be forced to pay a higher federal income tax simply by reason of the ownership of such securities. A simple example omitting the $10,000 floor should suffice to show that the ADR requires this result. Assume two taxpayers, each married and under 65 but with no dependents. Taxpayer A receives $50,000 in income from municipal bonds and has an adjusted gross income of $50,000 and deductions of $25,000. Taxpayer B has the same adjusted gross income and deductions but receives no tax-exempt interest. Taxpayer A will pay a federal income tax, disregarding the 10% surcharge, of $10,475, in contrast to Taxpayer B, who will pay a tax of $5,596, as follows:

	Taxpayer A		*Taxpayer B*	
Adjusted Gross Income		$50,000		$50,000
Tax-exempt municipal bond interest		50,000		none
Allocable Expenses	$25,000		$25,000	
Less:				
Amount Disallowed by ADR	12,500	$12,500	none	$25,000
Taxable Income		$37,500		$25,000
Tax		$10,475		$ 5,596

When prospective purchasers of tax-exempt securities realize that their right to deductions will be substantially eroded if either the House Bill or the Treasury proposal becomes law they may well curtail their purchases and even be forced to sell securities acquired since the cutoff date of July 11, 1969 in the House Bill. The incongruity of an individual who owns no tax-exempt securities paying less taxes than a taxpayer with the identical taxable income who accepts the lower interest rate borne by municipal bonds can have a serious impact upon the municipal bond market. The adverse effect of this potential interference with the borrowing power of states and municipalities stems primarily from the discriminatory disallowance of charitable contributions, state and local taxes, theft and casualty losses, and medical and dental expenses, none of which are even remotely connected with the receipt of tax-exempt interest.

In *National Life Insurance Company* v. *United States*, 277 U. S. 508, 522 (1928), the Supreme Court held that "Congress has no power purposely and directly to tax State obligations by refusing to their owners deductions allowed to others."

And yet this is precisely what happens under ADR as the foregoing example demonstrates. It is submitted that ADR plainly discriminates against those taxpayers (other than banks and other corporations) who receive state and municipal bond interest by compelling them to pay a higher tax than other taxpayers receiving the same amount of taxable income who do not own tax-exempt public securities.

C. *The Atlas Life Insurance Company case does not support ADR.*

United States v. *Atlas Life Insurance Company*, 381 U. S. 233 (1965), which considered the constitutionality of The Life Insurance Company Income Tax Act of 1959 does not support the ADR. That Act imposed a tax upon the taxable investment income of life insurance companies and upon one-half the amount by which total gain from operations exceeds taxable investment income. 73 Stat. 112, Code §§ 801-820. In arriving at taxable investment income, the Act recognized that life insurance companies are required by law to maintain policyholder reserves to meet future claims, that they normally add to these reserves a large portion of their investment income, and that these increments should not be subjected to tax. The Act defines life insurance reserves, provides a method for establishing the amount which for tax purposes is deemed to be added each year to those reserves, and prescribes a division of the investment income of an insurance company into two parts, the policyholder's share and the company's share.

Under section 804 the total amount to be added to the reserve is divided by the total investment yield and the resulting percentage is used to allocate each item of investment income, including tax-exempt interest, partly to policyholders and partly to the company. The effect of apportioning the annual addition to the reserve to nontaxable and taxable income *pro rata* is to limit the deductions allowed against taxable income to its proportionate part of the addition to the reserve. The remainder o each item is considered to be the company's share of investment income. In computing taxable investment income, the Act then allows a deduction of the company's share o tax-exempt interest from the total amount of investment income allocated to th Company.

Atlas claimed it was entitled to deduct from total investment income both the fu amount of the annual additions to the reserves and the full amount of tax-exemp interest received. The company argued that by assigning part of the exempt incom to the reserve account rather than assigning only taxable income, the Act places mo taxable income on the company's share of investment return, with the result that paid more tax because it had received tax-exempt interest.

The Supreme Court speaking unanimously stated that:

"... the policyholder's claim against investment income is sufficiently direct and immediate to justify the Congress in treating a major part of investment income not as income to the company but as income to the policyholders. 381 U. S. at 247-8

* * *

"Under the 1959 Act this portion is arrived at by subjecting each dollar of investment income, whatever its source, to a pro rata share of the obligation owed by the company to the policyholders, from whom the invested funds are chiefly obtained. In our view, there is nothing inherently arbitrary or irrational in such a formula for setting aside that share of investment income which must be committed to the reserves." 381 U. S. at 249

The Court pointed out that:

"The formula does pre-empt a share of tax-exempt interest for policyholders and the company will pay more than it would if it had full benefit of the inclusion for reserve additions *and at the same time could reduce taxable income by the full amount of exempt interest.* But this result necessarily follows from the application of the principle of charging exempt income with a fair share of the burdens *properly allocable* to it." 321 U. S. at 251 (italics supplied)

This treatment of tax-exempt income prevents, as it was intended to do, a double deduction. If life insurance companies could not only deduct *in full* the annual additions to reserves which were assigned to the policyholders but also *exclude* from their income the tax-exempt interest assigned to the policyholders, they would be in effect deducting tax-exempt interest which had already been excluded from their taxable income. Thus, life insurance companies would have an exemption and also a deduction for the same amount of tax-exempt interest.

The Court declined to consider any comparison of two life insurance companies which received the same amount of taxable income but one of which companies received tax-exempt municipal interest, pointing out that life insurance companies do not have a choice of investing or not investing but must invest either in one kind of security or another to accumulate funds for their policyholders and that the items of income and expense which entered into any computation of taxable income of a life insurance company were so interrelated that it was unrealistic to compare life insurance companies with different earning capacities in determining whether expenses were properly allocable to tax-exempt income. 381 U. S. at 250-1.

In so doing the Court accepted the distinction between an individual taxpayer and a life insurance company which had been urged upon it by the Department of Justice in its brief in the case. In the brief the Department had emphasized this distinction as follows:

"If we were dealing with a simple tax upon gross income received by a taxpayer *exclusively for his own benefit* without deductible costs, then it might be true to say that a tax liability which is increased because of the additions of an increment of State bond interest is, to some extent, a tax on the income from the bonds. But that is not this case; here we deal with the net income after sundry subtractions from the received income coming into the company's possession.

"... but the arithmetic is meaningless unless we also consider *whether the State-bond interest has such a relation to other items entering into the determination of taxable net income that the receipt or non-receipt of the State bond justifies a change in the corresponding elements of the arithmetical computation.*" Pet. Br., pp. 22-3 (italics supplied)

It is this very distinction which is so blurred by the self-contradictory language in the Report of the Ways and Means Committee that the draftsmen of the House Bill could not find words to insert in the bill which would limit the ADR to an allocation of deductions involving expenses reasonably attributable to the production and collection of the interest received by an individual (or an estate or trust) from state and municipal securities.

The Supreme Court in the *Atlas* case was not "dealing with a simple tax upon gross income received by a taxpayer exclusively for his own benefit," as the Government's brief in *Atlas* stressed. In *Atlas* the income was partly for the benefit of the taxpayer (i.e., the Company) and partly for the benefit of the policyholders. Hence, the allocation sanctioned by the Court in *Atlas* is a far cry from the sweeping disallowance of deductions not germane to tax-exempt income received by a taxpayer exclusively for his own benefit. To do what the House Bill would purport to do makes ADR an arbitrary and discriminatory rule.

III

Sections 601 and 602 of the Bill provide for unnecessary and undesirable Federal control of State and Local financing; the Subsidy Program provided for therein is unworkable.

Section 601 of the House Bill contains provisions which purport to authorize an issuer of obligations which are presently exempt under section 103(a)(1) of the Code to issue obligations which would not be subject to such exemption. The election shall be made with respect to each issue of obligations to which it is to apply and the election with respect to any issue once made shall be irrevocable. Section 602(b) of the bill provides that the Secretary of the Treasury or his delegate shall pay a fixed percentage of the interest yield on each issue of obligations to which the foregoing election applies before the first day of each calendar quarter. The Secretary or his delegate shall determine the fixed percentage of interest yield which he determines is necessary for the government to pay "in order to encourage the States and political subdivisions thereof to make elections under section 103(b)". During the calendar quarters beginning prior to January 1, 1975, the fixed percentage shall be not less than 30 percent and not more than 40 percent; for calendar quarters beginning after December 31, 1974, the percentage shall be not less than 25 percent and not more than 40 percent. Payment of any interest required shall be made by the Secretary of the Treasury or his delegate not later than the time at which the interest payment on the obligation is required to be made by the issuer.

Section 602(c) of the bill provides that, at the request of the issuer, the liability of the United States under section 602 to pay interest to the holders of an issue of obligations for which an election has been made shall be made through assumption by the United States of the obligation to pay a separate set of interest coupons issued with the obligations.

Section 601(b) of the bill provides that, under regulations prescribed by the Secretary or his delegate, any arbitrage obligation shall not be included within those obligations exempt from taxation under section 103.

The amendments relating to the subsidy program shall apply to obligations issued in calendar quarters beginning after the date of the enactment of those provisions. The amendment in respect of arbitrage obligations shall apply to obligations issued after July 11, 1969.

A. *Sections 601 and 602 of the bill provide a vehicle for continuing federal control of the purposes for which state and local obligations may be issued.*

In order to overcome the objections to a subsidy plan which are necessary to complement a program of taxable debt instruments to finance state and local government capital outlays, the provisions of sections 601 and 602 of the House Bill, according to the Report of the House Committee on Ways and Means, are "entirely elective" and the Report further states that there "is no review of the advisability of the local project or of the issuer's ability to repay". However, such a review will be required for the subsidy provisions of the bill apply only to obligations which, but for an election under proposed section 103(b), would be obligations to which section 103(a)(1) applies. Thus, neither industrial development bonds as defined in section 107 of the Revenue and Expenditure Control Act of 1968 nor arbitrage obligations would be eligible for the subsidy program. If Congress is concerned with tax reform it is incumbent upon it truly to reform the situation created by the unfortunate definition of industrial development bonds contained in section 107 of the Revenue and Expenditure Control Act of 1968 and to prevent the taxation of "arbitrage" obligations. As Senator Baker stated on May 27, 1969 in the Senate upon the introduction of S. 2280 in respect of section 107 of the Revenue and Expenditure Control Act of 1968:

> "... This measure originated by way of amendment on the Senate floor without the benefit of hearings in either House and was adopted after brief debate. Subsequent to adoption by the Senate of the Ribicoff amendment, a provision imposing the 10-percent surtax was also added to the same bill, and the attention of the Senate-House conferees, the other Members of Congress, and the country at large was naturally and appropriately focused on the all-important issues of the surtax and expenditure cut and not on the scope of the definition relating to industrial development bonds.

> Many Members of Congress who supported the taxation of industrial development bonds later came to realize that, as a result of the cursory treatment given this subject, Congress had by means of the definition employed in the act gone much further than was ever intended. It became generally acknowledged that Congress had not only provided for the taxation of industrial development bonds but had also made a wholesale attack on numerous State and local obligations completely unrelated to industrial development. Chairman Wilbur Mills of the House Ways and Means Committee, stated this fact on the floor at the time of passage of the conference report and invited the National Governors Conference and others to provide corrective legislation.
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> * * *
>
> The bill which I introduce today is essentially a revised version of the measure that I introduced late in the last session. Its purpose is to correct what most believe is clearly a distorted definition of the term "industrial development bond" as presently set forth in the statute."

Senator Baker has stated, and we fully concur, that section 107 of the Revenue and Expenditure Control Act of 1968 has the effect of including within the definition "industrial development bond" many bonds which would be issued to finance facilities for many "acknowledged and traditional State and local functions". He further stated at the time of the introduction of S. 2280:

> "...What the act [Revenue and Expenditure Control Act of 1968] does is set up a list of approved purposes labeled "exemptions." Bonds for these purposes remain exempt and those for all other State and local governmental purposes are, as I have said, taxable when private occupants pay to use the financed facilities.
>
> By establishing this honor roll rating, the Congress purported to classify as "good" or "bad" many legitimate functions of State and local governments, rewarding "good" purposes with exemption and penalizing "bad" purposes with taxation. Among the "bad" purposes are such fundamental governmental functions as education and health care, which obviously are totally unrelated to the development of new industrial plants, but the interest on the facilities of which is taxable if they are maintained by private occupants.
>
> * * *
>
> In my judgment, this type of continuing Federal regulation by the honor roll regulation of State and local governmental functions has no proper place in our federal system and accordingly should be abandoned."

Just as we support meaningful redefinition of the term "industrial development bond" we object to any congressional determination of "good" or "bad" purposes. The goodness or badness of purposes for which state or local obligations may be issued can best be determined by states and local government in accordance with state established concepts of public purpose and not by Congress.

The statutory authorization to exclude arbitrage obligations from the subsidy program and to include income derived from arbitrage obligations in the gross income of the recipients thereof is another ill-conceived congressional attempt involving federal review of the purposes for which state or local obligations may be issued. The Report of the House Committee on Ways and Means states that "[s]ome State and local governments have misused their tax exemption privilege by engaging in arbitrage transactions for which the funds from tax exempt issues are employed to purchase higher yielding federal obligations whose interest is not taxed in their hands." No examples of such arbitrage transactions are given. We know of no situation in which bonds have been issued in an arbitrage transaction as we believe that term to be used by the House and thus we have grave doubts as to the need for a legislative remedy for a supposed evil which does not exist. However, we are quite concerned that the term may be so defined to attack necessary and proper state and local financing methods. For example, it is quite common for state and local governments to invest in higher yielding taxable obligations pending the use of the proceeds of the bond issue. Such proceeds may be used for the construction of needed capital facilities or may be used to refund outstanding obligations. In either case it may be prudent, and indeed required, that the state or political subdivision invest those funds in the highest yielding and safest investments available to them including United States government securities, until such time as they can be used for the purpose for which they are intended.

The Report states that "it is contemplated that the regulations to be issued by the Secretary of the Treasury concerning this section of the bill will provide rules for the temporary investment of the proceeds of a state or local government obligation pending their expenditure for the governmental purposes which gave rise to their issue." However, neither the bill nor the Report provide the Secretary with any discernible standard as to what type of arbitrage obligations will be included in the definition promulgated by the Secretary of the Treasury.

We assume, but are uncertain, that the term as used in the House Bill has the ambivalent meaning given to it in the Treasury Department announcement contained in Technical Information Release No. 840, dated August 11, 1966. That Release stated that a study would be conducted to determine whether certain obligations should be considered as obligations of states, territories, possessions and their political subdivisions or the District of Columbia. The obligations which were to be the subject of the study were "obligations issued by these govermental units where a principal purpose is to invest the proceeds of the tax exempt obligations in taxable obligations, generally United States Government securities, bearing a higher interest yield."

Pending such study, the Treasury Department announced in the Release that it would decline to issue rulings that interest on obligations falling within two categories would be exempt from federal income taxation under section 103 of the Code.

The obligations were those

> "1. Where all or a substantial part of the proceeds of the issue (other than normal contingency reserves such as debt service reserves) are only to be invested

> in taxable obligations which are, in turn, to be held as security for the retirement of the obligations of the governmental unit.
>
> 2. Where the proceeds of the issue are to be used to refund outstanding obligations which are first callable more than five years in the future, and in the interim, are to be invested in taxable obligations held as security for the satisfaction of either the current issue or the issue to be refunded.''

The Treasury Department then gave three examples of transactions where no rulings would be issued. The examples were

> "First, a State may issue obligations and invest the entire proceeds in United States bonds with similar maturities bearing a higher interest yield. The United States bonds are then placed in escrow to secure payments of interest and principal on the States obligations. The profit on the interest spread accrues to the State over the period of time that these obligations are outstanding.
>
> Second, a municipality may immediately realize the present value of the arbitrage profits to be derived over the future by casting the transaction in the following form: It may issue obligations in the amount of $100 million, use $20 million to build schools or for some other governmental purpose, and invest the balance, $80 million, in United States bonds which bear a higher interest yield. The United States bonds are escrowed to secure payment of interest and principal on the municipal obligations. The interest differential is sufficiently large so that the interest and principal received from the United States bonds are sufficient to pay the interest on the municipal obligations as well as to retire them at maturity.
>
> Third, a municipality may issue obligations for the stated purpose of refunding outstanding obligations first callable more than five years in the future. During the interim before the outstanding obligations are redeemed the proceeds of the advance refunding issue are invested in United States bonds bearing a higher interest yield, and such bonds are escrowed as security for the payment of either of the issues of municipal obligations. During that interim period, arbitrage profits based on the interest spread inure to the municipality.''

If the Treasury Department has completed its study it has not announced the results thereof[*] and therefore we express grave doubts of the need for a legislative remedy. We can understand the concern of the Treasury Department in respect of the problem presented by the first category or the first and second examples so long as their concern is expressed with respect to transactions where all or a substantial part (80%) of the proceeds of the issue are to be solely for the purpose of investment in taxable obligations and have no other purpose such as the refunding of outstanding obligations where such refunding is permitted by state or local law or the instruments pursuant to which such outstanding bonds being refunded were issued. We are of this view for it would be difficult to find a public purpose if the language means what it says. We assume that the first category does not apply to refunding bonds for it appears to have been the intent of the Treasury Department to deal with refunding in the second category. It would be impossible to justify an argument that the first category would include such refunding obligations where they are callable less than five years in the future. The second category and the third example set forth in the Release could prevent a financing which involves a justifiable public purpose under state law and the facts underlying the financing program. There is no valid reason for Congress to impose its will in respect of the desirability of particular financing programs of state and local governments by denying the tax exemption to income derived from bonds of such state and local governments for such otherwise justifiable purposes.

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[*] The tax reform studies and proposals of the Treasury Department submitted to the Committee on Ways and Means of the House of Representatives on January 17, 1969 make no reference to arbitrage obligations. See *Tax Reform Studies and Proposals, U. S. Treasury Department*, Joint Publication, Committee on Ways and Means, U. S. House of Representatives and Committee on Finance, U. S. Senate, Washington: Government Printing Office, 1969.

We further express our concern over the provision in the bill which states that the provisions in respect of arbitrage bonds shall apply to obligations issued after July 11, 1969. Since the statute provides no discernible standard as to what type of arbitrage obligations will be included in the definition promulgated by the Secretary of the Treasury and since the provisions of the bill relating to arbitrage obligations are retroactive to July 11, 1969, issuers of securities will be unable to determine whether their obligations will be deemed to be arbitrage obligations the income of which will be subject to federal income tax and which will not be obligations to which the subsidy program will apply.

B. *The subsidy plan is unworkable in several respects.*

The subsidy program is unworkable as applied to any political subdivisions of a state. Assuming that a state can exercise the election provided by section 601, it would appear that a political subdivision of the state would be unable to exercise such an election without a grant of authority to do so. We are not aware that any state presently has authorized its political subdivisions to exercise such an election.

A political subdivision is merely a creature of the state and derives all of its power from the state. It is a general and undisputed proposition of law that a municipal corporation possesses and can exercise only those powers expressly granted, those necessarily or fairly implied in or incident to the powers expressly granted and those essential to the accomplishment of the declared objects and purposes of the corporation. Any fair, reasonable, substantial doubt concerning the existence of power is resolved by the courts against the corporation and the asserted power is denied. Neither the corporation nor its officers can do any act, or make any contract or incur any liability not authorized by its charter or the statute creating it, or by some other legislative authorization. All acts beyond the scope of powers granted are void. The power of the legislatures of the states to control their respective political subdivisions without hinderance, so far as the federal constitution or its laws are concerned, has been consistently recognized by the Supreme Court. The only restraint on this broad authority is that such exercise of power shall not contravene a federally protected right of one to whom that right is guaranteed. See *Hunter* v. *Pittsburgh,* 207 U. S. 162 (1907); *Gomillion* v. *Lightfoot,* 364 U. S. 339 (1960); *Baker* v. *Carr,* 369 U. S. 186 (1962). Thus where the City of Baltimore challenged, under the equal protection clause of the Fourteenth Amendment of the federal constitution, a state statute exempting a railroad from a City ad valorem tax, the Supreme Court rejected the City's contention of unconstitutionality with the assertion that a municipal corporation "has no privileges or immunities under the federal constitution which it may invoke in opposition to the will of its creator". *Williams* v. *Mayor and City Council of Baltimore,* 289 U. S. 36, 40 (1933).

Consistent with these well-defined concepts of state law, since there is no legislation of which we are aware in any state authorizing, implicitly or explicitly, the issuance of taxable bonds, it would appear that no political subdivision of any state has the power at present to issue taxable bonds notwithstanding the passage of the bill.

In order for a municipality to be empowered to elect to issue taxable bonds each state would have to pass enabling legislation and in some states the state constitution would need to be amended prior to the passage of such enabling legislation. Anything less than passage of state legislation would entangle a political subdivision desiring to make an election in protracted litigation testing the power of such political subdivision to exercise such election without enabling state legislation. Such litigation, of course, would have to be resolved prior to selling taxable obligations. As a practical matter no political subdivision would welcome delay in financing needed projects resulting from the time required to (1) enact necessary legislation or (2) to await the outcome of litigation, the success of which is conjectural.

The bill provides that the Secretary or his delegate "shall pay a fixed percentage of the interest yield on each issue of obligations" to which an election applies. The Committee report states that "[d]etermination of the interest yield on any issue of obligations is to be made immediately after they have been issued." It must be assumed that the term "interest yield" means return on investment to a bondholder based on the cost of the bond. The choice of the term "interest yield" is unfortunate for it relates to an amount to be received by the purchaser of the state or local obligations and not to the amount of interest payments required to be made by the state or local government, i.e. "interest rate". Since we are dealing with a subsidy plan to "encourage the States and political subdivisions thereof to make elections under section 103(b)" the amount of interest to be paid or interest rate would appear to be the proper criterion. However, since the percentage is to be based on "interest yield" the interest yield may be computed to maturity or to the earliest possible redemption date. If computed to the earliest date of redemption, no subsidy payments would be available on interest payment dates subsequent to the earliest redemption date if those obligations were not redeemed. No adjustments for redemption are specifically provided for in the bill. However, it is reasonable to assume that adjustments will be required depending on the redemption date and the redemption price. However, even though there is no specific statutory basis for the view that an adjustment would be made the implication of such authority furthers the contention that there will be a substantial amount of federal control in respect of obligations to which the election applies, not only with respect to the purpose for which the obligations are issued but details of the financing transaction which are a necessary incident to such financings. This is further evidenced by the Committee Report's statement in respect of premium or discount applied in the issuance of obligations:

> "...Where it is the most practicable method of effecting the intent of the bill, adjustment for any premium or any discount at which the obligations are issued may be made between the issuer and the United States at the time of issuance or such later time or times as may be appropriate."

Section 602(c) of the bill provides that at the request of the issuer, the liability of the United States under Section 602 to pay interest to the holders of an issue of taxable obligations shall be made through assumption by the United States of the obligation to pay a separate set of interest coupons issued with the obligations. This dual coupon concept has not to our knowledge been extensively explored by the legal community associated with the issuance and sale of state or local obligations. As a result substantial legal problems may exist. Thus while the Committee Report concedes that "the use of such dual coupon obligations might be necessary to avoid violation of the maximum interest rate limitations imposed on some States and localities by local law", a review of those limitations leads one ineluctably to the conclusion that the limitations would still apply.

While we have briefly discussed the provisions of the proposed subsidy plan and the ramifications resulting therefrom, we would like to call attention to the amount of federal control which appears from the various provisions. Reference has been heretofore made to some of the items of control. The federal government would be required to have personnel available to undertake the various responsibilities, including those mentioned below, which appear explicitly or implicitly in the language of the bill. First, the federal government would appear to be required to satisfy itself that the obligations to be issued were valid and legally binding obligations of the state or political subdivision. The extent of the government's involvement in this particular role would vary with each issue of obligations. Second, contemporaneously with such review the federal government would have to satisfy itself that the obligations to be issued would not be deemed to be industrial development bonds within the meaning of the Revenue and Expenditure Control Act of 1968 or arbitrage obligations. Third, determinations of interest yield would be required to be made by the federal government in respect of each issue of obligations. The exact amount of the interest yield would be of such importance to each issuer that an official of the federal government would have to be available upon the receipt of the bid for or upon the negotiation of the sale of an issue of obligations to confirm such amount. Fourth, machinery would be required to be established to provide that the federal government's share of the interest payments would be made not later than the time at which the interest payments on the obligations are required to be made by the issuer. Finally, personnel would also be required to make adjustments in the subsidy payments in the event that taxable obligations were redeemed prior to maturity. No discussion of the necessity of administering the foregoing functions appears to have been heretofore considered by Congress. The Committee Report is silent as to the need for the creation of administrative machinery and no reference is made to the cost of such administrative machinery in that section of the Committee Report relating to "Revenue effect."

For the reasons set forth above, we recommend that sections 601 and 602 of the bill not be enacted.

Respectfully submitted,

HAWKINS, DELAFIELD & WOOD
67 Wall Street
New York, New York 10005

Dated: September 19, 1969

STATEMENT OF MR. JEFFREY GREEN, CHIEF, FINANCE DIVISION, LAW DEPARTMENT, PORT AUTHORITY OF NEW YORK AND NEW JERSEY, NEW YORK, N.Y.

Senator ARMSTRONG. Mr. Green, Jeffrey Green, speaking on behalf of the Municipal Finance Officers Association.

Mr. GREEN. Thank you, Senator.

Today I'm appearing on behalf of the MFOA to testify in support of Senate bill 1113, which as everybody has said, would repeal this indirect tax on interest on State and local government obligations.

The association has a longstanding position against proposals, whether by legislation, regulations or otherwise, that may reduce or otherwise impair the marketability of tax-exempt obligations issued by our State and local governments or otherwise increase the interest cost of those obligations by reducing the unqualified nature of tax exemption.

The provision in the 1983 social security amendments that mandates this tax, providing that tax-exempt interest be taken into account with all other income in determining the amount of social security benefits to be taxed, represents, in our view, an infringement on the unqualified tax-exempt status of these obligations.

As a preliminary matter, let me say that State and local government officials were strongly supportive of the efforts of the National Commission on Social Security Reform to strike a compromise that would save the social security system from bankruptcy, and recognized that every participant in the system, including States and local governments—and I might add that States and local governments participate voluntarily in the system, and not by congressional mandate—would be called upon to make some financial sacrifice. As the employers of more than 13 million employees, 70 percent of whom are covered by social security, and with a total annual payroll exceeding $17.5 billion, our interest in securing the future financial solvency of the system is as great as that of any other sector of the economy.

In addition to the provisions affecting all employers generally, State and local governments contributed toward the financial reform of social security in two important ways. I might add that coming down on the plane today I saw an interview with Senator Dole in the Eastern Airlines Review in which he said that the social security bill must be a good bill because everybody is objecting to it, because everybody had to contribute something.

State and local governments contributed something toward the social security bill through the accelerated payment schedule of social security taxes and through the elimination of the withdrawal option for covered State and local government units.

The acceleration of the social security tax payments from a monthly to a biweekly basis will result in additional administrative burdens on State and local governments. The MFOA has analyzed this provision and estimated that the requirement will involve an additional financial burden of approximately $150 million.

Let me explain why at this critical time for the municipal markets we believe this bill should be passed.

First and foremost among our concerns is the public perception of the inclusion of interest on State and local government obligations in the base against which the taxation of social security benefits is to be measured. This will drive up the interest rates paid by State and local governments while providing relatively little benefit to the social security system. Nobody claims that this bill is a revenue raiser for the Federal Government. Everybody agrees that this bill has very little revenue impact. This rise in interest cost will be due to the fact that municipal bonds may well be perceived as increasingly unattractive to individual bondholders.

This important sector of the market will be deprived of the full value of the exemption for which it is already paying by accepting lower interest rates. As the president of the National Conference of State Legislatures has written to Senator Armstrong, on July 29, "In this atmosphere, even changes perceived as minor by some take on important dimensions." We believe that this is the wrong message at the wrong time and that Senate bill 1113 corrects that message.

It is essential that this subcommittee recognize that banks and insurance companies, which have traditionally acquired 80 to 90 percent of available tax-exempt securities, have begun to withdraw from the market, and have been replaced by the individuals and by small trust funds. And it is in these sectors that it is particularly important to avoid the perception of imposing an indirect tax.

To digress for a moment, the Treasury's lack of an impact analysis on this piece of legislation is not surprising because, although over the years Treasury has continually, as Senator Long pointed out, attempted to tax in one way or another interest on State and local government obligations, Treasury, to the best of my knowledge, has never furnished to this committee, to the Municipal Finance Officers Association or to any other organization of State and local governments their impact analysis. And more importantly, Treasury has never disclosed their assumptions. We've seen some numbers released by Treasury of the presumed input of various measures, but we have never seen the analyses or the assumptions. I would suggest that in any future legislation that this committee considers that Treasury be asked, as Senator D'Amato asked Mr. Pearlman before, to provide an impact analysis, together with their assumptions, in order to assist this committee in its review of legislative proposals.

Yet undoubtedly, the national policy change imposed by the Social Security Act will be perceived, as Mr. Lebenthal said, as a warning to future purchasers of municipal bonds that tax-exempt income may not be fully immune in the future from Federal taxation. A very dangerous precedent may be set that could cost public issuers millions of dollars each year at a time when borrowing costs are already at historically high levels.

The social security legislation is particularly troublesome because it unfortunately continues a trend, whether intended or not, which is seriously lessening the attractiveness of municipal bonds, and already thereby added significantly to our interest costs.

Furthermore, we fail to understand why tax-exempt interest has been singled out as the only addition to the income base, and subjected to the so-called means test, putting municipal bonds at a further disadvantage in competing for the limited dollars seeking tax-free investments.

In 1982, a minimum tax on individuals' income, which included interest earned on State and local obligations, was wisely rejected by the Senate because it violated the important constitutional guarantee against taxation of the interest from State and local bonds. For many of the same reasons, it is equally important to rescind the social security amendment affecting tax-exempt interest.

Mr. Chairman, State and local officials are united in their support of this bill. The National League of Cities, the National Association of Counties, the U.S. Conference of Mayors, the National Conference of State Legislatures, and the National Governors Association have asked the Municipal Finance Officers Association to express their support here today for Senator D'Amato's bill, S. 1113.

Mr. Chairman, I request permission to have my complete remarks included in the record.

Senator ARMSTRONG. We will be happy to do so, and we appreciate very much your observations.

Thank you, Mr. Green.

[The prepared statement of Mr. Green follows:]

TESTIMONY

OF THE

MUNICIPAL FINANCE OFFICERS ASSOCIATION

Mr. Chairman and members of the Subcommittee my name is Jeffrey S. Green. I am Chief of the Finance Division in the Law Department of The Port Authority of New York and New Jersey. Today I am appearing on behalf of the Municipal Finance Officers Association to testify in support of S. 1113 which will repeal an indirect tax on the interest of state and local government obligations. This tax was enacted earlier this year as part of the Social Security Amendment of 1983. The Municipal Finance Officers Association is a professional organization representing 9,200 state and local government finance officials, appointed and elected, and other public finance specialists.*

The Municipal Finance Officers Association has a long-standing position against proposals, legislation or regulations that may reduce or otherwise impair the marketability of tax-exempt obligations issued by state and local governments or increase the interest costs of such obligations by reducing the unqualified nature of the tax exemption. The provision in the 1983 Social Security Amendments that mandates that tax-exempt interest be taken into account along with other income in determining the amount of Social Security benefits to be taxed represents, in our view, an infringement on the unqualified tax-exempt status of these obligations. This provision greatly concerns those of us actively engaged in providing and financing needed public projects and programs because it may well drive up the cost of state and local government borrowing with a concomitant increase in state and local taxes and user charges.

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*Questions concerning this testimony should be directed to Catherine L. Spain, Director, Federal Liaison Center, Municipal Finance Officers Association, 1750 K Street, N.W., Suite 200, Washington, D.C. 20006 (202) 466-2014.

As a preliminary matter, let me state that state and local officials were strongly supportive of the efforts of the National Commission on Social Security Reform to strike a compromise that would save the Social Security System from bankruptcy and recognized that every participant in the system would be called upon to make some financial sacrifice. As the employers of more than 13 million employees, 70 percent of whom are covered by Social Security, and with a total annual payroll exceeding $17.5 billion, our interest in ensuring the future financial solvency of the Social Security System is as great as any other sector.*

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*David Koitz, Social Security: Withdrawal by State and Local Governments and Nonprofit Organizations (Washington: Congressional Research Service, October 1982) p.50

In addition to the provisions affecting all employers generally, state and local governments contributed toward the financial reform of Social Security in two other important ways. The 1983 legislation will step up the frequency of payment of Social Security taxes by state and local governments and, more importantly, it purports to prohibit any further withdrawals by covered state and local units.

The acceleration of Social Security tax payments from a monthly to biweekly basis will result in additional administrative burdens on state and local governments. As recently as 1979, the collection of state and local Social Security taxes was also accelerated from a quarterly to monthly schedule. The monthly system allowed states that collect and account for payments from thousands of independent jurisdictions the necessary time to provide accurate payments and information to the federal government. The Municipal Finance Officers Association analyzed this most recent change and estimated that the requirement will place an additional financial burden of approximately $150 million on states and localities due to the elimination of interest earnings that may have been used to offset administrative costs and even greater administrative demands.

The prohibition of any additional state or local units withdrawing from social security coverage seeks to curtail an increasingly popular option. Previously, state and local governments which had voluntarily elected to be covered under Social Security could terminate that coverage if the employer gave two years written notice of such intent, provided the unit had been covered for at least five years. It should be noted that as of the date of enactment of the Social Security Amendments of 1983, approximately 450 employers had termination notices on file.

While we supported the work of the Commission and saw the need for certain changes in the Social Security laws affecting states and localities, we strongly opposed the U.S. Senate-initiated provision to include tax-exempt interest in the income base of Social Security beneficiaries. We believed then and believe now that it represented an indirect tax that will be harmful to states and localities. In addition, we noted it was not a Commission recommendation and was not contained in the U.S. House of Representatives version of the reform legislation.

Let me explain why at this critical time for the municipal markets we believe S. 1113 should be passed. First and foremost among our concerns is that this indirect federal tax on interest on state and local government obligations will drive up the interest rates paid by state and local issuers while providing relatively little benefit to the Social Security system. This rise in interest costs will be due to the fact that municipal bonds may become increasingly unattractive to individual bondholders. This important sector of the market will be deprived of the full value of the exemption, for which it is already paying by accepting lower interest rates.

This is the wrong message at the wrong time. It is essential that this Subcommittee recognize that banks and insurance companies, which have traditionally acquired 80 to 90 percent of available tax-exempt securities since 1980, have also recently begun to withdraw from the market causing tremendous reliance on the individual sector. According to recent Federal Reserve Flow of Funds data, the household sector and mutual funds are currently absorbing 80 percent of the new supply of tax-exempt debt.

Unfortunately, markets operate in such ways that it is difficult to assess exactly how much more public entities will have to pay in interest costs as bondholders seek protection from the possible dimunition of tax exemption. The Municipal Finance Officers Association's Government Finance Research Center has analyzed the impact of this provision on the municipal bond market and estimates that it will result in a 25 to 50 basis point increase -- which is equivalent to a one-quarter to one-half of a percentage point rise. The table on the next page shows the annual impact on a state-by-state basis assuming that the volume of short-term and long-term tax-exempt borrowing remains at the 1982 level. It can be seen that the interest cost is expected to increase between $299 and $599 million each year.

These numbers demonstrate quite clearly that the projected increase in revenue to the U.S. Treasury resulting from this provision -- an estimated $5 million over a seven year period -- is small in comparison to the impact it will have on state and local borrowing costs. We think the majority of the Members of Congress did not intend to burden state and local governments with higher interest costs and urge that S. 1113 be enacted to remedy this situation.

Increased Borrowing Costs for State and Local Governments Resulting from the Social Security Amendments of 1983

	Estimated 1982 Long- & Short- Term Tax-Exempt Debt Issued (000's)	Estimated Annual Increase in State & Local Government Borrowing Costs (000's)	
		LOW (.25%)	HIGH (.50%)
ALABAMA	1810141	4525	9051
ALASKA	2081625	5204	10408
ARIZONA	2816365	7041	14082
ARKANSAS	905536	2264	4528
CALIFORNI	10179461	25449	50897
COLARADO	3300524	8251	16503
CONNETICU	1821701	4554	9109
DELAWARE	647478	1619	3237
FLORIDA	6383228	15958	31916
GEORGIA	2557148	6393	12786
HAWAII	651372	1628	3257
IDAHO	111156	278	556
ILLINOIS	5193304	12983	25967
INDIANA	1768725	4422	8844
IOWA	665331	1663	3327
KANSAS	879794	2199	4399
KENTUCKY	1964197	4910	9821
LOUISIANA	3802505	9506	19013
MAINE	557354	1393	2787
MARYLAND	2396307	5991	11982
MASSACHUS	3684334	9211	18422
MICHIGAN	3073446	7684	15367
MINNESOTA	2462827	6157	12314
MISSISSIP	1101827	2755	5509
MISSOURI	1171480	2929	5857
MONTANA	406232	1016	2031
NEBRASKA	968029	2420	4840
NEVADA	1031827	2580	5159
NEW HAMPS	427253	1068	2136
NEW JERSE	3889733	9724	19449
NEW MEXIC	1385662	3464	6928
NEW YORK	8455203	21138	42276
NORTH CAR	3117377	7793	15587
NORTH DAK	384301	961	1922
OHIO	3839358	9598	19197
OKLAHOMA	1458179	3645	7291
OREGON	1462411	3656	7312
PENNSYLVA	3945621	9864	19728
RHODE ISL	310200	775	1551
SOUTH CAR	2647272	6618	13236
SOUTH DAK	248372	621	1242
TENNESSEE	1843409	4609	9217
TEXAS	10526240	26316	52631
UTAH	1144817	2862	5724
VERMONT	343552	859	1718
VIRGINIA	2762000	6905	13810
WASHINGTO	4584938	11462	22925
WEST VIRG	388446	971	1942
WISCONSIN	1631027	4078	8155
WYOMING	545049	1363	2725
TOTAL	119733674	299334	598668

We consider the inclusion of tax-exempt interest income in the base of social security recipients particularly unfair as it applies to present recipients. Beneficiaries who are bondholders will begin to feel the effects beginning in January 1984, yet they have planned for their retirement years and purchased municipal bonds with the expectation that the interest earnings from these investments would be completely free of taxation. Undoubtedly, this national policy change will be taken as a warning by future purchasers of municipal bonds that tax-exempt income is not fully immune from federal taxation. A dangerous precedent may be set that will cost public issuers millions of dollars each year at a time when borrowing costs are already at historically high levels.

The Social Security legislation is particularly troublesome because it unfortunately continues a trend whether intended or not, which has seriously lessened the attractiveness of municipal bonds and thereby added significantly to interest costs. Specifically, the following events have occurred:

- A reduction in personal income tax marginal rates, especially the lowering of the top-bracket rate from 70 percent (on unearned income) to 50 percent for all income. The rate reductions are scheduled to continue at a rate of 10 percent a year, with indexation commencing in 1985. Thus, starting in late 1981, the long-term prospects were for progressively lower rates into the future.

- A reduction in the capital gains rate, which dropped from a maximum of 28 percent to 20 percent. Over the long haul, this change should accent the attractiveness of holding equities in comparison to fixed-income securities, such as municipal securities, a particularly important trade-off in the case of wealthly investors.

- The expansion of various competing income-sheltering opportunities, the partial exemption of interest through the Utility Dividend Reinvestment Program, and the creation of the All Savers Certificate.*

- The partial removal of the deductibility of bank interest costs used to finance the purchase of tax-exempt securities.

Furthermore, we fail to understand why tax-exempt interest has been singled out as the only addition to the income base and subjected to the so-called "means test" putting municipal bonds at a further disadvantage in competing for the limited dollars seeking tax-free investments. For example, beneficiaries are not required to include the following other untaxed income or special deductions:

- accelerated cost recovery system write-offs,
- investment tax credits,
- dividend exclusions, and
- capital-gains exclusions.

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*It is interesting that at a time when the traditional exemption from federal income taxes of interest on state and local government obligations was being threatened -- an exemption guaranteed by the U.S. Constitution -- Congress extended tax exemption to the All Savers Certificate, a widely available short-term instrument that was federally guaranteed.

We submit that this is unfair and discriminatory treatment for states and localities who are "partners" with the federal government in our intergovernmental system, who have current massive infrastructure and other capital needs and who must rely on the bond market for necessary funds.

Recently, the Supreme Court in American Bank and Trust Co. et al. v. Dallas County et al. held that the Texas tax on bank shares violates federal law because it includes the value of federal obligations in computing the tax. This ruling reversed an earlier decision by the Texas Court of Civil Appeals by barring the Texas tax on the basis of a federal law which provides that U.S. obligations shall be exempt from taxation by states and localities.* While this decision will adversely impact Texas cities financially, it is being hailed as a victory for states and localities because, if carried to its logical extension, it strengthens the principle of reciprocal immunity.

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*Rev. Stat. section 3701, 31 U.S.C. section 742.

In 1982, a proposal to impose a minimum tax on individuals' income, which included interest earned on state and local obligations, was rejected by the Senate because it violated the important constitutional guarantee against taxation on the interest from state and local bonds. For many of the same reasons, it is equally important to rescind the Social Security Amendments affecting tax-exempt interest.

Mr. Chairman, state and local officials are united in their support of S. 1113. The National League of Cities, the National Association of Counties, the U.S. Conference of Mayors, the National Conference of State Legislatures and the National Governors' Association have asked us to express their support for S. 1113 today.

STATEMENT OF MR. ROBERT S. McINTYRE, DIRECTOR OF FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE, WASHINGTON, D.C.

Senator ARMSTRONG. Finally, Mr. Robert S. McIntyre. Mr. McIntyre.

Mr. McINTYRE. Thank you, Mr. Chairman. I'm happy to be here today on behalf of Citizens for Tax Justice. I want to say at the outset that I was glad to hear you talk about Professor Olson's book today. That's a book I've recently read, and I found very compelling his theory that interest groups are the main source of our economic problems.

I have spent most of my career fighting interest groups, often before this committee. And today I'm here again to try to persuade you that what the interest groups are telling you is wrong.

I think we've heard the issue before the subcommittee misstated so often today that it is important to get back to ground zero. S. 1113 reminds me more than a little of safe harbor leasing. As you may recall, in 1981 some rather generous tax breaks for business investment were enacted. And then to frost the cake, leasing was added to allow companies who couldn't fully use those tax breaks to take advantage of them anyway.

Well, I bring that up because this year when the social security bill was passed, a very large new tax incentive for certain people to invest in municipal bonds was created. Much larger than under old law. S. 1113 would take that new incentive that was created in the social security bill and add to it. We have some examples in our testimony of how that would work. You have all seen similar examples that your staff and the staff of the Joint Tax Committee have put together for you. The numbers are fairly clear.

Let us just look briefly at one example here on page 3 of my testimony. In this case, we start with a retired couple in a situation where prior to the social security amendments, they were indifferent between buying tax-exempt or taxable bonds. The after-tax difference between one and the other is only $54 a year.

Under current law as enacted by the Congress last winter, they now have a very significant incentive to invest in tax-exempt bonds. A $630 a year incentive. The reasons for that are fairly straightforward. First, because social security will be partially taxable, they are in a higher tax bracket. Second, less of their social security will be taxable if they buy municipal bonds as opposed to taxable bonds, even with the formula enacted by Congress.

Now, if we adopt Senator D'Amato's proposal, we will increase that new incentive to buy tax-exempt bonds compared to old law by another 50 percent. That certainly wasn't Congress intent—to increase the incentive for municipal bonds when it enacted the social security bill. And, in fact, Congress did its best to limit the amount of the new incentive, by including municipal bond interest in the base for taxing social security.

Moreover, Congress also concluded that, just as someone who has $35,000 in taxable income must now pay tax on social security, so also should someone with $100,000 of municipal bond income, simply as a matter of fairness. We believe that was a sensitive, equitable conclusion.

Now, of course, people can say that there are other loopholes out there and until we get rid of them all, we can't fight any of them. That's the position, I think, of many people here in Washington. And, in fact, I think there are people who will support any and all loopholes as long as any exist. With all due respect, we think that position is silly.

What it inevitably leads to, obviously, is enacting every tax-exemption proposal that is put forward. And, ultimately, it means funding the Government entirely on debt. Now the current administration has leaned that way, but even they, I think, are backing away from that position—that we should borrow to finance the entire budget.

So in conclusion, it seems to us that it is fairer to keep the law where it is. And, second, it makes no sense to provide an additional incentive on top of the one you have already provided for people to buy tax-exempt securities. S. 1113 would provide a lot of business for lawyers and accountants in reshuffling their clients' portfolios, but it won't do anything good for the country.

Thank you. I'm sorry not to go over my time.

Senator ARMSTRONG. Thank you very much.

[The prepared statement of Mr. McIntyre follows:]

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Statement of Robert S. McIntyre
Director, Federal Tax Policy, Citizens for Tax Justice
Before the Senate Finance Subcommittee on Social Security
and Income Maintenance Programs
Concerning S. 1113, Relating to the Inclusion of Tax-Exempt
Interest in Computing the Floor for Taxing Social Security Benefits
August 1, 1983

Thank you for the opportunity to appear before the Subcommittee today concerning S. 1113, Senator D'Amato's proposal to repeal the recently enacted rule requiring that tax-exempt interest be taken into account in computing the floor for taxing Social Security benefits.

Citizens for Tax Justice is a coalition of labor, public interest, and citizens groups working to improve the tax laws at the federal, state, and local levels. Through our member organizations we represent the interests of tens of millions of middle- and lower-income Americans, who have a vital stake in fairer and economically more sensible tax laws.

Last spring, Congress took needed action to rescue the troubled Social Security system. One step was, in effect, to reduce benefits for upper-income Social Security recipients. For unmarried beneficiaries with incomes exceeding $25,000 and for couples earning more than $32,000, up to half of Social Security benefits are now subject to income taxation. Although this change will not affect most recipients, in some cases it will cut benefits by as much as 25 to 30 percent.[1] It is expected to add $26.6 billion to federal receipts between 1983 and 1989.

A critical question that had to be addressed in setting the income floors below which Social Security benefits will remain untaxed was how to define "income." After deliberation, Congress decided to base the calculation on adjusted gross income, but with several exclusions from AGI disallowed. These include the 10 percent second-earner deduction, the exclusion for foreign earned income, the exclusion for income earned in a U.S. possession, and tax-exempt interest.

During the Senate floor debate in March, Senator Long proposed dropping tax-exempt interest from the list of disallowed exclusions. His amendment was rejected by the full Senate on a roll call vote of 44 to 52. In S. 1113, Senator D'Amato has reintroduced that amendment, and it is now before this Subcommittee. We oppose S. 1113, and urge the Subcommittee to reject it.

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[1] Social Security recipients in the 50 percent income tax bracket will find one-quarter of their benefits recaptured by federal income taxes, and in many cases also will owe additional taxes at the state level.

Congress had two excellent reasons for choosing to take account of tax-exempt interest in computing the floor for taxing Social Security benefits. First, there was the obvious inequity of, for example, taxing Social Security benefits in the case of a couple with $32,000 in dividend income, but exempting a couple with $20,000 in dividends and $100,000 in interest on Industrial Revenue Bonds. Second, Congress was properly concerned over providing too large an added incentive for upper-income Social Security recipients to shift funds into tax-free bonds.

Senator D'Amato has argued that S. 1113 is necessary to eliminate a positive *disincentive* to investment in tax-free bonds, which he says was created by the 1983 Social Security changes. This argument might carry more weight were it not demonstrably incorrect. In fact, the new rules for taxing Social Security benefits already provide a significantly greater incentive for investment in tax-exempt bonds than did prior law. Senator D'Amato's bill would simply add to that new incentive.

The accompanying examples illustrate this point. In Example A, we have a couple with $13,314 in Social Security benefits, $17,000 in dividends, and the choice between $12,000 in tax-exempt interest or $15,000 in taxable interest.[2] Under prior law, the couple would have little incentive to choose tax-free bonds. Their net tax savings from buying tax-exempts of $3,054 would be almost completely offset by the $3,000 in lower interest they would receive.

Under current law, however, the couple will find a distinct gain from purchasing tax-free rather than taxable bonds. Not only will the taxable interest option subject a higher portion of their Social Security benefits to tax, but they will be in a higher tax bracket. As a result, tax-exempt bonds will have a $637 advantage over taxable bonds.

Under Senator D'Amato's proposal, this advantage would increase by 50 percent, to $929. This result occurs because the couple pursuing the tax-exempt option would pay no tax at all on their Social Security benefits.

Example B deals with a much wealthier couple, whose choice is between $100,000 in tax-exempt interest and $125,000 in taxable interest. Here again, current law's treatment of Social Security benefits increases the incentive to purchase tax-free bonds over that provided by prior law, this time by $1,965 And here again, S. 1113 would augment this new incentive, by an additional $1,297 per year.

During the Senate floor debate, Senator Long and Senator D'Amato also complained that tax-free interest had been unfairly singled out for harsh treatment, while income sheltered by such tax preferences as accelerated depreciation, percentage depletion, the expensing of intangible drilling costs, and a variety of other special tax breaks was not required to be added

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[2] According to the August 1, 1983 issue of *Business Week*, *Bond Buyer*'s 20-bond index of tax-exempt municipals is currently paying a 9.54% interest rate. This is 85% of the rate on taxable U.S. government long-term issues and 77% of the yield on taxable new Aa industrial bonds. Our examples assume that the yield on tax-exempts is 80% of the taxable rate.

HOW THE 1983 SOCIAL SECURITY AMENDMENTS INCREASED INCENTIVES FOR UPPER-INCOME SOCIAL SECURITY RECIPIENTS TO PURCHASE TAX-EXEMPT BONDS, AND HOW SENATOR D'AMATO'S BILL (S. 1113) WOULD INCREASE THOSE INCENTIVES STILL FURTHER

Example A. A retired couple, filing a joint return, no itemized deductions, with income as follows:

Social security benefits:	$13,314
Dividends:	$17,000
EITHER taxable interest:	$15,000
OR tax-exempt interest:	$12,000

1. **Pre-1983 Social Security amendments** ***(old law)***:

With taxable interest option, AGI equals $32,000. Tax equals:	$4,315
With tax-exempt interest option, AGI equals $17,000. Tax equals:	1,261
Change in tax:	$3,054
Loss in interest:	3,000
NET ADVANTAGE FROM TAX-FREE BONDS:	*$ 54*

2. **Post-1983 amendments, tax-exempt interest included in computing floor for social security benefit taxation** ***(current law)***:

With taxable interest option, AGI equals $35,328. Tax equals:	$5,190
With tax-exempt interest option, AGI equals $18,828. Tax equals:	1,553
Change in tax:	$3,637
Loss in interest:	3,000
NET ADVANTAGE FROM TAX-FREE BONDS:	*$ 637*

3. **Post-1983 amendments, tax-exempt interest** ***not*** **included in computing floor for social security benefit taxation** ***(S. 1113)***:

With taxable interest option, AGI equals $35,328. Tax equals:	$5,190
With tax-exempt interest option, AGI equals $17,000. Tax equals:	1,261
Change in tax:	$3,929
Loss in interest:	3,000
NET ADVANTAGE FROM TAX-FREE BONDS:	*$ 929*

Example B. A retired couple, filing a joint return, no itemized deductions, with income as follows:

Social security benefits:	$ 13,314
Dividends:	$ 20,000
EITHER taxable interest:	$125,000
OR tax-exempt interest:	$100,000

1. **Pre-1983 Social Security amendments** ***(old law)*:**

With taxable interest option, AGI equals $145,000. Tax equals:	$52,114
With tax-exempt interest option, AGI equals $20,000. Tax equals:	1,741
Change in tax:	$50,373
Loss in interest:	25,000
NET ADVANTAGE FROM TAX-FREE BONDS:	*$25,373*

2. **Post-1983 amendments, tax-exempt interest included in computing floor for social security benefit taxation** ***(current law)*:**

With taxable interest option, AGI equals $151,657. Tax equals:	$55,376
With tax-exempt interest option, AGI equals $26,657. Tax equals:	3,038
Change in tax:	$52,338
Loss in interest:	25,000
NET ADVANTAGE FROM TAX-FREE BONDS:	*$27,338*

3. **Post-1983 amendments, tax-exempt interest** ***not*** **included in computing floor for social security benefit taxation** ***(S. 1113)*:**

With taxable interest option, AGI equals $151,657. Tax equals:	$55,376
With tax-exempt interest option, AGI equals $20,000. Tax equals:	1,741
Change in tax:	$53,635
Loss in interest:	25,000
NET ADVANTAGE FROM TAX-FREE BONDS:	*$28,635*

back to AGI in computing the floor for taxing Social Security benefits.

This argument is not without force as a debating point. We might add that it becomes more and more difficult to defend the income tax as fair to the wage-earners we represent when we see preferences sheltering most personal income from capital from taxation, when Congress imposes withholding on wages but repeals it for interest and dividends, and when the corporate income tax has all but disappeared due to loopholes.

But the argument ultimately proves far too much. If we cannot move to close some loopholes because of the existence of others, if, in fact, we cannot even take a position against adding new preferences so long as others remain extant, then we must logically repeal all the tax laws and fund the government entirely on debt. With all due respect to the current administration, which sometimes seems intent on doing just that, we find such a result absurd.

On the other hand, we welcome expressions of concern about tax fairness, and we have numerous tax reform proposals that we hope Congress will consider this year if and when it takes action to meet the revenue targets it has set for itself in its budget.

In conclusion, we again urge the Subcommittee to reject S. 1113. Its enactment would reduce tax equity by allowing some high-income Social Security recipients to escape taxation of their benefits, while others in similiar or worse circumstances will be subject to tax. S. 1113 would also add to the increased incentive for investment in tax-free bonds already created by the 1983 Social Security changes, sending tax lawyers and accountants around the country scurrying to amend their clients' investment portfolios for no sensible economic reason.

Senator ARMSTRONG. There was a time when I might have laughed at your suggestion that we might finance the entire Federal Government by borrowing, but sometime in recent days that doesn't seem like such a preposterous idea.

Senator Long, did you have questions for members of the panel?

Senator LONG. Yes. I would like to ask a question or two. This gentleman at the end, what's your name?

Mr. GREEN. Jeff Green.

Senator LONG. Mr. Green, is it not so that, whenever the Federal Government talks in the term of how much money it is going to make by taxing the income on State and municipal bonds, it ought to consider what that action is going to cost State and municipal governments?

Mr. GREEN. Yes, Senator.

Senator LONG. Now if all you are doing is simply trying to shift money from the pockets of the State government into the pockets of the Federal Government, as far as the taxpayer is concerned, there is no benefit to him. Is that correct or not?

Mr. GREEN. That's correct.

Senator LONG. I see. Well, that's the way it seems to me. And, if we increase the cost of your bonds by more than the Federal Government picks up in taxes, then, as far as taxpayers are concerned they are no worse off. As far as I know, every citizen who is contributing taxes to the Federal Government is also contributing taxes to the State or a local government. And where you increase the overall cost to the taxpayer by an amount greater than you pick up for the Federal Government, you've increased his taxes. Now is that right or not? I don't know whether it is. What do you think?

Mr. GREEN. Well, it's particularly egregious in this case, Senator, because the numbers indicate that there is minimal revenue impact to the Federal Government from the original proposal, and yet the cost to State and local government goes into the hundreds of millions of dollars annually. So it is particularly bad in this case.

Senator **Long**. Now, Mr. Lebenthal, you referred to this act of Congress, which we passed, to make it against the law for the State and local governments to put a tax on income on our bonds. What was the date of that bill?

Mr. **Lebenthal**. Thirty-seven zero one. Sir, let me make sure that I understand. The law that I referred to, the Federal law, Revenue Statute 3701, I believe, was originally passed sometime in the 1870's. That was on the books always. Is that the law you are talking about in reference to my comment?

Senator **Long**. Yes.

Mr. **Lebenthal**. States can't tax Federal obligations. That law was on the books. In 1948, Idaho got cute and enacted this tax in spite of that law. The law was amended in 1959. I don't know what took the Congress 11 years. I guess this is not its favorite subject. But in 1959 that law was tightened up. And I would be delighted to read it. It takes a small amount of fishing.

Senator **Long**. Well, that's all right. Let's just put it in the record.

[The information from Mr. Lebenthal follows:]

Stocks and obligations of the United States Government are exempt from taxation by a State or a political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except—

(1) A nondiscriminatory franchise tax or another nonproperty tax instead of a franchise tax, imposed on a corporation; and

(2) An estate or inheritance tax.

(Citation: 31 U.S.C. 3124(a).)

Mr. **Lebenthal**. It couldn't be more plain. And more than that, only last month, Senator, the Supreme Court of the United States in *American Bank and Trust Co.*, v. *Dallas County* upheld that law, and knocked down a State of Texas tax on bank shares because it failed to diminish the value of those shares by the Federal obligations represented by the bank's capital.

Senator **Long**. So then, the Federal Government has passed laws in both regards. One, to say we won't tax the income on State and municipal bonds. Two, to say that States can't tax the income on Federal bonds.

All right. Now, doesn't all of this go back to the old case of *McCulloch* v. *Maryland* where the Court said—wasn't that Chief Justice Marshall speaking for the Court at that time—that there is a reciprocal immunity.

Mr. **Lebenthal**. Senator, I'm with you 100 percent. And I had hoped I could get through this testimony without once having to say *McCulloch* v. *Maryland, Pollock* v. *Farmers Home Loan* and dragging out every one of those schoolboy cases that has been used as evidence in 1969 when we had the limited tax preference tax, the allocation of deductions tax. And it was dragged out in 1982 when we had the minimum tax again.

But what we have here—and I don't want to be facetious about this—the aroma of tax-free municipal bond. It's tantalizing. And like apple pie on a window sill. And it is always going to come under the gun like this, and it always does come under the gun when you hurry these deliberations through. But the minute you have open hearing, you drag it out, you drag out *McCulloch* v. *Maryland,* you drag out poor old Justice Marshall, you drag out *Pollock* v. who knows who—when deliberation is focused in on the subject, by golly, if we don't straighten up and fly right.

Senator LONG. Thank you very much.

Senator ARMSTRONG. Haven't we seen you on television? [Laughter.]

Mr. LEBENTHAL. I apologize.

Senator ARMSTRONG. Not at all. As a matter of fact, I am told in fact you are featured on television now and again in New York. And I didn't mean that to poke fun at you, but really to compliment you. You are the first person I know of to really flavor your testimony in exactly this way. And I happen to agree with you also. But I found it very interesting.

Mr. LEBENTHAL. Thank you.

Senator ARMSTRONG. Senator Chafee agrees with you as well, I think. [Laughter.]

Senator CHAFEE. Well, as a matter of fact——

Senator ARMSTRONG. How about the part about obsession with forbidden fruit. What do you think about that?

Senator CHAFEE. I think that's very accurate. Are you here representing the PSA?

Mr. LEBENTHAL. Yes, sir.

Senator CHAFEE. The PSA came forward with this little pamphlet which I would rank as trash. We were inundated with this same sort of thing from the banks in connection with the repeal of the withholding in interest and dividends. I'm not holding you responsible for this, but I am holding the group to which you belong responsible for this publication. Statements like "Beginning next January 1, thousands of retired owners of municipal bonds will be forced to have the Federal Government count the interest from their municipal bonds in computing their tax liability," are misleading.

That's playing with the truth, in my judgment. Let me read another example: "If Congress can tax one class of municipal bond holders, what will be next? All investors will begin to question," and so forth. I wasn't convinced by this material.

You can report back to PSA that they didn't make a sale in this instance. I don't think your pamphlet will convince others either.

Let me ask Mr. Green a question. Mr. Green, you stated the dire consequences that could occur within the municipal bond market if this legislation remains intact and Senator D'Amato's bill does not pass. Are you saying that the new social security law, which includes the Chafee amendment, if you want to call it that, will decrease demand for bonds? Or are you saying that the bond demand will not be as great as it would be if Senator D'Amato's bill passed?

Mr. GREEN. Senator, it is very difficult to ascertain the reasonableness of a particular estimate. What we are saying is that the interest cost to State and local governments will increase by a conservative $300 million to $600 million, assuming a one-quarter to one-half percent increase in our borrowing cost. And that's a result of, No. 1, a decrease in demand for the bonds and, No. 2, an increase in the interest that we will have to pay because of the perception of the social security provision by the growing number of individual investors in the bond market—and we are talking perception, Senator—just as many of the speakers before me spoke about the perception of equity. We are talking about the perception of municipal bonds to the individual segment of our investing public.

Senator CHAFEE. I tell you what. We are working within a time limitation, and I have another appointment myself. However, did you listen carefully to the examples given by the Treasury Department and Mr. McIntyre showing that in some instances, within this small category that we have been talking about so much today, there will actually be an increased demand for tax-free municipal bonds?

Mr. GREEN. I'm sure there are instances where that may well be the case. But there are also instances where that will not be the case. And where demand will be off. And every time we turn around, we see somebody else's estimates of the effect of this particular piece of legislation. And I welcome staff of the Senate Finance Committee and staff of the Treasury to sit down with the Municipal Finance Officers Association staff and other interested representatives of State and local government to work out the impact of this particular piece of legislation.

Senator CHAFEE. Well, you know, what is happening and you are more of an expert in this area than I am. However, I think one of the things that has changed the rates for municipal bonds and reduced the differential is the flooding of the market by a host of tax-exempts, such as IDB's or housing mortgage bonds or whatever. You are really dealing with very large figures there.

Mr. GREEN. There are many factors that go to reducing the differential, Senator, including the reduction of the maximum tax on capital gains and, the reduction of the maximum tax on unearned incomes.

Senator CHAFEE. Thank you. Now, Dr. Roberts, I listened to your testimony, and the dire problems you pointed out. Of course, what you are really objecting to is what you say in your written statement on the top of page 4: "Taxation of benefits should never have been included in the 1983 amendments." That's your principal complaint before this committee, isn't it?

Dr. ROBERTS. One of them.

Senator CHAFEE. One of them? I would say it's the major one, but I don't think you are going to get this committee or this Congress to change that. At least I hope you are not.

Dr. ROBERTS. I don't know if anybody will ever get any Congress to deal realistically and straightforwardly with the social security problem. And the fact that you don't do that is why you always end up in these kinds of messes. If you faced the issue straight on and dealt with it, nobody would have to be here today testifying on this one because it wouldn't have ever come up. There wouldn't have been any need to tax benefits. There wouldn't have been any need to drag municipal bonds into it. And we would have a social security system that was not going to produce a long-term deficit.

Senator CHAFEE. I'm not sure I agree with you on that.

Dr. ROBERTS. But I think you are right that the Congress probably isn't going to deal with the real problem.

Senator **Chafee**. I would like to make one statement in conclusion. I think we are going to need every nickel we can get to maintain the social security system, primarily because of a variety of factors that we didn't consider to the extent that we should have. The Commission, which the chairman sat on, may have. The main factors I am referring to is the increase in longevity in the United States, but that issue is not before the committee today.

Dr. **Roberts**. The point is the rate at which the benefits grow. As long as you have the benefits growing at the rate scheduled in the law, there is no amount of tax increases that is going to make it possible to pay those benefits.

Senator **Chafee**. Well, that's linked to the inflation.

Dr. **Roberts**. Oh?

Senator **Chafee**. Is that what you are saying?

Dr. **Roberts**. No, it's not. It's due to the wage indexing of the initial retirement benefit of each retiring generation. The way they are indexed, benefits, basically, are growing faster than the economy that has to support them.

Senator **Chafee**. Well, I was not arguing that. That may well be true. I wasn't on the Commission. I think we have got a lot of deep problems in the social security system that present us with cause for great concern. Everything isn't in splendid shape through the year 2020, but I don't think the taxation of benefits is one of the things we ought to change, as I have indicated before.

Thank you, Mr. Chairman.

Senator **Armstrong**. Senator, I can tell you that you missed a fine experience not being on that social security——

[Laughter.]

Senator **Chafee**. Well, I thought the nation was well represented.

Senator **Armstrong**. I appreciate that, but I wanted to tell you that there is a good chance we are going to be having another one of those once-in-a lifetime commissions very soon. And we will put you down for the next one.

Senator **Chafee**. Well, thank you for that honor. What did Lincoln say about being ridden out of town on a rail? But for the publicity, I would just as soon forego it. [Laughter.]

Senator **Armstrong**. Senator D'Amato.

Senator **D'Amato**. Thank you, Mr. Chairman.

I am wondering, Mr. Lebenthal, with the passage of the Social Security Act that included the provisions as it relates to municipal bonds, the Chafee amendments, does that make municipal bonds more or less desirable? As the law stands now, with the inclusion of the income for taxable purposes calculated in the threshold, does that make municipal bonds more or less desirable?

Mr. **Lebenthal**. Senator, I saw a piece of literature somewhere along the line that tried to see a silver lining around that cloud. And I threw it away. It is a poke in the eye as opposed to a punch in the belly. I see no virtue in it insofar as the bond market is concerned. And what is more, I do not see your bill as an enhancement of the municipal bond market. All your bill does is restore neutrality. Brings us back to where we were.

May I go on for a moment?

Senator D'AMATO. Do you see it as making municipal bonds more or less desirable?

Mr. LEBENTHAL. I see the bill, as it stands now, as making the bonds less desirable.

Senator D'AMATO. What happens when bonds are less desirable?

Mr. LEBENTHAL. When they are less desirable through an interesting process, investors force the price of those bonds up until the level has restored that which you have taken away.

Senator D'AMATO. Can you make an estimate as to what we may encounter as a result of this in terms of that price increase for municipal bonds?

Mr. LEBENTHAL. Senator, I have tried to, and it depends so much on what the SEC and the NASC, which are the bond industry's regulatory bodies, are going to mandate we say about this nontax. [Laughter.]

It depends on what Lebenthal & Co. and the 300 municipal bond firms represented by the Public Securities Association—what their own bond attorneys mandate they say in the name of full disclosure. Oh, I guess, that I might try to swallow every word that I have said here and write something that—this wasn't a tax on municipal bonds. It was only a measurement.

But I might not. It depends on factors that none of us know. It depends on publicity. It depends on any number of things. But there is going to be some sort of risk premium. I'm not talking about the risk premium when your bonds are going to default and go belly up. I'm talking about the risk premium when you buy a fixed-income investment you are asked to put your money in the 30-year bond of some place you have never heard about or have heard all too much about, and you now have another risk you have got to take into account. Will the arithmetic basis for making this investment stand up in futuro? You ask that question, you pay for it.

Senator D'AMATO. Now when those costs go up, higher interest, who pays for that?

Mr. LEBENTHAL. I do. He does. You do. We all do in a different role. All of a sudden we take off our hats as Federal taxpayers; we become John Q. Public who is paying for the local sewer system. We all in that other role pay for the increased cost of borrowing.

Senator D'AMATO. Financing of a local municipal improvement—bridges that collapse, highways, sewers. All that is going to cost more?

Mr. LEBENTHAL. Yes, sir.

Senator D'AMATO. The finance?

Mr. LEBENTHAL. Yes, sir.

Senator D'AMATO. What about this outrageous statement put out by PSA? I haven't seen it before. I would like to get some. "Beginning next January 1, thousands of retired owners of municipal bonds will be forced by new social security laws to report their taxes and income to the Federal Government and to count the interest from municipal bonds in computing their tax liability." Is that true or not?

Mr. LEBENTHAL. True, sir. And it is outrageous because it is. [Laughter.]

Senator D'AMATO. I don't want you making any of those television commercials against me. [Laughter.]

Mr. LEBENTHAL. Sir, you gave me a fright there a little earlier. [Laughter.]

Senator D'AMATO. Thank you, Mr. Chairman.

Senator LONG. I'd like to ask another question.

Senator ARMSTRONG. Go right ahead.

Senator LONG. Let me say, Mr. Lebenthal, I don't see anything in your publications that I haven't either attempted to say or go beyond. Now I haven't undertaken to say that it was going to make a grave difference to the bond issuer when the case goes to court over the constitutionality of taxing these State and municipal bonds. Now let's just assume that that case goes on up to the Supreme Court. How are people who are being asked to invest in State and municipal bonds are going to feel about it when they are contesting right there in the court the power of the Federal Government to tax them just as though it is General Motors stock. It's going to shake them up.

Mr. LEBENTHAL. It's going to shake them up.

Senator LONG. Now Treasury had for years been trying to tax these bonds, but the Congress wouldn't let them do it. But now we have got the situation where Mr. Chafee's amendment sets the stage for changing all that.

State and local governments are going to have to challenge this attempt to tax them. Now when they do, and that case gets up to the Supreme Court, are all those bond buyers are going to be saying, "Hold up. Let's wait and see what the Court said about this."

Mr. LEBENTHAL. I truly believe that to be the scenario.

Senator LONG. Now I've been involved in taxing things that have not been taxed before. We could have taxed these bonds with a grandfather clause by saying, well, all the bonds that are now out will not be taxed, and those who now hold them are protected. For the future, if you buy one of these bonds, you pay the tax. It wasn't done here, was it?

Mr. LEBENTHAL. No, sir. And I certainly am not going to sit here and advocate that because if it is wrong in past—if it is wrong retroactively, it is wrong prospectively. Do you understand my response, sir?

Senator LONG. Sure. Are you familiar with the fact that one of the reasons that people would invest in the bonds was that they would feel that their tax-exempt status wasn't likely to be challenged? And that even if challenged, Congress wouldn't go along with it.

Mr. LEBENTHAL. Precisely, sir. Because when I have explained to my clients what is going on here, their first response is that Congress wouldn't, that Congress couldn't, and I then have to come and say the Congress did. [Laughter.]

It is incredulous.

Senator LONG. Now that's a matter I have been trying to explain to Senators. That they are setting the stage for the tax-exempt status of their State and local governments to be challenged. And when the challenge goes to court, it's going to mean that all these bonds will bear more tax—not just the social security beneficiaries.

Bonds in the hand of anybody buying them. They won't command the low interest rate they command today or the low interest rate we would hope they would command, because the tax-exempt status will be in doubt. Congress has undertaken already to tax them right in midstream for people who bought them with the understanding that they would be exempt from tax. In violation of its own commitment to the American people, Congress passed a law to tax these bonds as far as these social security beneficiaries were concerned. And that is going to shake up bond purchasers. And it's going to have to make the interest rates go up.

Up until now a lot of people don't know about it. We just had a witness in here from State and municipal government about some other matter—revenue sharing or something—and when I asked him about this matter of Congress taxing State and municipal bonds, he didn't know it had happened. He wasn't aware of it.

Mr. LEBENTHAL. It is amazing that municipal bond investors, these up-scaled, back-taxed Park Avenue millionaires, Harvard graduates, whatever they are supposed to be, it's absolutely amazing that they have canceled their subscriptions to their newspapers, they don't watch the 6 o'clock news, but the fact is they have no perception of this bill until a piece of scurrilous literature in the exercise of democracy, which sometimes does get loud—my own voice being not so mute testimony to that—they discover through this sort that, yes, some kind of an injustice has been done. And then we go back and we try to correct it.

Senator LONG. Well, somebody reads your little publication here and they say, "What is this? Don't tell me Congress is taxing these State and municipal bonds."

Senator CHAFEE. You think people are going to be upset at the taxation of municipal bonds, what they are going to think when they discover half their social security benefits are being taxed. I don't think that everybody is wandering around in a complete fog.

Mr. LEBENTHAL. No.

Senator CHAFEE. As far as the constitutionality of this law, there is no question that it is unconstitutional. It says it right here in the PSA pamphlet: "Please help appeal this unfair, unproper, improper, and unconstitutional law." People don't even have to go to court. It says it right here.

Mr. LEBENTHAL. Well, sir, you don't have to go to——

Senator CHAFEE. Go, PSA tells us.

Mr. LEBENTHAL. Sir, you don't have to go to court.

Senator CHAFEE. It's——

Mr. LEBENTHAL. Senator, I don't think I should be contentious and argumentative.

Senator CHAFEE. Maybe you've got two of them. No, I think they are the same.

Senator ARMSTRONG. You've got the original. I could only scrounge up [laughter]——

Senator LONG. I just want to say to Dr. Roberts that I am going to study the statement carefully—your analysis—as to how this marginal rate actually goes above 100 percent. The Secretary of the Treasury told me at the time we were passing this measure that that was in the bill. And he said that in some cases the marginal rate actually went above 100 percent. And he was concerned about it. He thought maybe we might work it out at some future point or something.

And I didn't really understand it at that point. And the members of the minority staff tell me that what you are saying is correct. That it does tend to have that effect.

And I'm concerned about that. And I hope that we can straighten it out.

Now would you mind being a little more explicit in how you think we should have gone about handling that social security problem, because while you are here, I think you ought to tell us that.

Dr. ROBERTS. Certainly, Senator. In fact, in the testimony I just gave to the Quadrennial Advisory Council on social security, which I am submitting as part of my statement today, it is outlined completely.

All you have to do is change one index from a wage index to a price index. It's the index that sets the initial benefit level of each cadre of retirees. That is, each generation of retirees. Take that off of a wage index and put it on a price index, and you have altered the rate at which the growth of those benefits takes place over time. Instead of, say, tripling, they would only double. Instead of doubling, they would only grow by, say, 50 percent. It doesn't stop the growth of the benefits, but it reduces the growth of the benefits to a level that the currently scheduled social security taxes can stand.

That's all you have to do. It won't affect anybody who is retired or anybody who is about to retire. They won't see any cut in their benefits. There can't be any political backlash. It only affects the growth of benefits in the future. And that will put the system whole. It will free up revenues that can be switched over to fund the hospital insurance, which is going to run some huge deficits in the future. And it lets you completely repeal the taxation of social security benefits altogether because it's not a drop in the bucket compared to what you can do by fixing that one index.

Senator LONG. Well, for your information, I voted against the conference report on the social security bill. I believe Senator Armstrong did also.

Senator ARMSTRONG. I did, indeed, because the conference deleted the so-called Long amendment, which was essential to the social security of the fund.

Senator LONG. But it wasn't just for that reason I voted against it. My amendment would have put a fail-safe provision in there that if you don't have enough money to pay the benefits, you just have to reduce future increases across the board so that you can pay for what you have. And that was on the theory that we wouldn't put ourselves deeper in debt if the cost of the program should exceed our expectations.

But by the time the conference was over and I had had a chance to think about all this, I was thoroughly convinced we were breaking the faith with the people who are on the rolls; we were doing things we said we would never do, including taxing these social security benefits.

Dr. ROBERTS. Right.

Senator **Long**. Not to mention taxing the State and municipal bonds. And it seemed to me that people who were backing that conference report were proudly saying that all of us are being compelled to do things we said we would never do. My thought was we didn't have to break faith with the people. We could have done the kind of thing you suggested here, and it wouldn't have broken faith with anybody. And it just would have meant that we couldn't live up to the future expectations of some people.

And I really believe that we should have corrected the problem along the lines you are talking about rather than the way we did which was to break our word with everybody on God's green Earth one way or another. And then they attempt to justify that by saying "But you see everybody is being required to break his word * * *" and all this. It won't achieve its purposes, and we are going to be right back to the same problem all over again. And I say that as a fellow who was a manager of that previous attempt to rescue the social security system in 1977.

Dr. **Roberts**. Well, everything you have said is right. I agree with it entirely.

Just to sum up the problem, real social security benefits are growing at the same rate as wages in the economy, but the retirees are growing faster than the work force. So the way the system is, there is no way you can make it whole. You've already had this mish-mash that Senator Long described so accurately. And if you don't do something about the real problem, you are going to end up with another mish-mash on top of this one. See what I mean? It is just trouble after trouble after trouble.

Senator **Long**. While all these involved in this fiasco were proceeding to break their word about social security, they also did something else they said they weren't going to do in putting these taxes on State and municipal bonds. And I hope that one of these days we can clean some of that up. I think most of that was a mistake. And I'm sorry I find myself in disagreement with some of our people here like you, Mr. McIntyre, but I just don't think the Constitution ever intended to tax those State and municipal bonds. You are right on the constitutional point. It would be a loophole. I just don't happen to think that under the Constitution it was ever intended that the Federal Government had a right to tax the State governments, including those State and municipal bonds. That's where you and I part company.

Mr. **McIntyre**. We don't think it is taxing——

Senator **Long**. Pardon me?

Mr. **McIntyre**. We certainly don't think that the 1983 social security amendments have resulted in the taxation of municipal bonds. In fact, it's a little hard to understand why anyone would think so. If you are worried about municipal bonds—and you certainly should be given the current state of the market—you should be pleased that the social security amendments, even with the Chafee provision, created greater incentives for retirees to buy bonds. Instead of complaining, you should be cheered up, Senator D'Amato.

Senator **D'Amato**. Well, I must be in another world.

Mr. **McIntyre**. I think so.

Senator **Long**. Well, thank you.

Senator **Armstrong**. A cheerful, but somewhat confusing note. [Laughter.]

Senator **D'Amato**. Mr. Chairman?

Senator **Armstrong**. Senator D'Amato, I would sort of like to end this. I'd like to just put in the record one profound thought that would sort of crystalize all this. Unfortunately, no such thought has entered my mind.

Did you want to have the last word?

Senator **D'Amato**. No, I didn't. I simply wanted to take the opportunity to commend you, Mr. Chairman, for not only holding these hearings and giving us the opportunity to put forth this bill, but also in such an extraordinarily diligent, patient manner. And I mean that very, very sincerely. And I think we all owe you a debt.

Senator **Armstrong**. Well, I appreciate your encouragement.

We are all indebted to you for raising the problem, and to Senator Long who raised it also last year.

Senator **Long**. Mr. Chairman, I'd like to submit a statement I have prepared for this occasion.

Senator **Armstrong**. Of course, we will do that.

Unless there is anything further, we stand adjourned.

[Whereupon, at 6:18 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

AMERICAN
ASSOCIATION
OF RETIRED
PERSONS

August 9, 1983

Mr. Roderick A. DeArment, Chief Counsel
Senate Committee on Finance
219 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Mr. DeArment:

Please include the following statement of the American Association of Retired Persons in the record of the Subcommittee on Social Security and Income Maintenance Programs' hearing on S. 1113, which was held on August 1, 1983.

The American Association of Retired Persons supports S. 1113, which would prohibit the inclusion of income from tax-free bonds in calculating the amount of social security benefits to be taxed. The taxation of benefits provision, which was passed as a part of the Social Security Financing Amendments of 1983 (P.L. 98-21), requires a social security beneficiary to add tax-exempt interest to adjusted gross income and to one-half of the social security benefit to determine whether a tax is owed on the social security benefit.

The Association believes that the inclusion of tax-exempt interest causes some social security recipients to be treated less favorably by the tax system than all other taxpayers. While tax-exempt interest is used to determine additional tax liability for social security beneficiaries, it is entirely ignored by other taxpayers for personal income tax purposes. For example, a person who receives no social security and $10,000 of tax-exempt interest is not required to use this interest to move himself or herself into a higher tax bracket. However, $10,000 of tax-exempt interest could significantly raise the tax liability of a social security recipient.

The tax-exempt interest rule will only affect people who are near the $25,000 ($32,000 for a couple) threshold. Because

Arthur E. Bouton
AARP President

Cyril F. Brickfield
Executive Director

National Headquarters 1909 K Street, N.W. [illegible] (202) 872-[illegible]

the threshold phases out quickly, many people with incomes above it will pay tax on one-half of their benefits, regardless of the tax-exempt income provision. It is those who are close to the threshold and have tax-exempt income who are harmed by the unequal treatment the tax code places on them.

Additionally, while the entire taxation of social security benefits implemented by P.L. 98-21 abruptly changes the tax rules for people who have completed their retirement planning, the inclusion of tax exempt income in the threshold is particularly onerous. People purchased tax-exempt bonds with the expectation that their tax status will be fixed. Instead, Congress has mandated that the income derived from existing bonds will be used to increase certain retirees' tax liability.

S. 1113 would correct the inequities caused by the inclusion of tax-exempt income in the social security taxation threshold. While the Association would prefer to see an entire repeal of taxation of benefits, S. 1113 is an appropriate step that can be taken at little cost to the social security trust funds.

Sincerely,

Peter W Hughes

Peter W. Hughes
Legislative Counsel

PWH:SZ

Frederic A. Powers
Certified Public Accountant
2374 Madison Road
Cincinnati Ohio 45208
(513) 871-6820 621-2299

AUG 8 1984

Mr. Roderick A. DeArment, Chief Counsel,
Committee on Finance
Room 219, Dirksen Senate Office Building
Washington D.C. 20510.

Dear Sir;

In considering testimony on S. 1113 regarding the proposed repeal of the inclusion of tax exempt income in the base for taxing social security income, the Senate Finance Subcommittee should not overlook the great injustice being done to formerly working married couples by the extreme exacerbation of the marriage penalty.

Two individuals who have worked and saved and invested separately, as much as each could from his or her earnings to provide for old age, should not be penalized merely because they are married, regardless of whether they married each other before or after retirement.

The discrimination arises from the threshhold resulting from the $25000 base for singles with only a mere $32000 for marrieds filing jointly and, unbelievably, ZERO for marrieds filing separately.

Some States do not allow separate State income tax filing unless separate federal returns have been filed, even though they do not provide a different rate schedule for marrieds. This further aggravates the marraige penalty.

Equality between singles and marrieds would call for a $50000 base in place of $32000 for marrieds; but in no case should it have been less than $40000.!

In its present form the act certainly diminishes the incentive for supplementing ones income through part time employment or, particularly through part time self employment, what with paying doubled self-employment taxes and, in most cases deriving no increase in social security benefits from the additional efforts. The Treasury might even collect less in social security taxes though this disincentive.

The people hurt the most are the middle and the lower-middle income groups. The table below shows an increase of 257 percent in the marriage penalty. The comparison is between a married couple's tax and the aggregate tax of two singles. The presently scheduled 1984 rates are used.

The assumptions are as follows:

Each individual has:

$20000 adjusted gross income

$18000 taxable income

$10000 social security income

	MARRIED COUPLE	TWO SINGLES	MARRIAGE PENALTY
ADJUSTED GROSS INCOME	$40,000	$40,000	
TAXABLE INCOME	36,000	36,000	
SOCIAL SECURITY	20,000	20,000	
TAX BEFORE THE ACT	6,538	5,382	$ 1,156
TAX AFTER THE ACT	9,508	5,382	4,126
INCREASE IN TAX -- $$	$ 2,970	$ -0-	$ 2,970
INCREASE IN TAX -- %%	45.4%	-0-	257.%

Yours very truly

Frederic A. Powers

Frederic A. Powers

P.S. The 1981 tax, before the Economic Recovery Tax Act of 1981, would have been $8506. So the tax after the social security act, $9508, is an increase over the 1981 tax amounting to $1002 or 11.78%.

IT ISN'T FAIR !

STATEMENT OF
INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)

on the

UNEMPLOYMENT COMPENSATION EXTENDED BENEFITS PROGRAM

Submitted to the

SUBCOMMITTEE ON
SOCIAL SECURITY AND INCOME MAINTENANCE PROGRAMS
of the SENATE FINANCE COMMITTEE

August 1, 1983

The UAW is pleased to present its views on the changes in the Extended Benefit Program enacted under the Omnibus Budget Reconciliation Act of 1981.

The Omnibus Budget Reconciliation Act instituted severe eligibility restrictions for the 13 additional weeks of benefits available under the Extended Benefit Program to exhaustees of regular state benefits. This legislation drastically cut back on eligibility by:

(a) eliminating the national trigger;

(b) excluding extended benefit recipients from the calculation of the state extended benefit triggers;

(c) requiring a 20 to 25% increase in the state extended benefit triggers (by raising the necessary targets by one percentage point);

(d) requiring twenty weeks of work for extended benefit eligibility.

These changes have led to sharp cutbacks in budget outlays, but at the expense of several million unemployed workers. If not for the first two changes, extended benefits would have been paid in all states beginning in May 1982, nearly one year after the onset of the recession. Exhaustees of regular state benefits in many states had to wait until mid-September to receive additional weeks of benefits under the Federal Supplemental Compensation program.

The impact of these legislated changes on workers in the hardest hit states has been even more devastating. In the midst of severe unemployment, the Extended Benefit Program triggered "off" in Michigan between December 1981 and March 1982; the State's unemployment rate of 12% was then the highest in the country. This unfortunate situation was nearly repeated this past winter as the State's insured unemployed rate fell below the 6% threshold for the four weeks immediately preceding the effective date of this higher trigger. Fortunately, the combination of an increase in regular state benefit recipients and a decline in the number of covered workers pushed the State's thirteen-week insured unemployment rate just barely above 6%. In nine other states,[1] however, extended benefit payments were suspended last October as the higher threshold requirements came into effect.

Though the economy is beginning to emerge out of its deep recession, the problem of high joblessness will not dissipate for many months and even years to come. Moreover, the cutbacks in the Extended Benefit Program are continuing to inflict suffering on the long term unemployed. The National Bureau of Economic Research recently pronounced that the 1981-82 recession bottomed out in November 1982 while the official unemployment rate peaked at 10.8% in December. The stock market has been predicting a recovery since last summer, and indeed wealthy investors and brokerage firms have been reaping huge gains over the last year. Unfortunately, millions of unemployed workers have yet to see or feel the end of recession.

The unemployment statistics point to nearly 11.6 million workers without jobs in June, including 2.8 million who were jobless for 27 weeks or more. In June 1981, the last month before the recession began, total unemployment was less than 8.5

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1. Alaska, Arizona, California, Louisiana, Montana, Nevada, North Carolina, Rhode Island, and Utah.

million, with 1.1 million long term unemployed. In addition to the 11.6 million workers counted as unemployed, another 6.6 million were working on a part-time basis and were interested in full-time work, and another 1.6 million were too discouraged to even search for jobs. On a seasonally adjusted basis, the civilian unemployment rate dropped to 10.0% by June, down from last December's post-depression record of 10.8%. However, unemployed workers are now jobless for an average of 22.0 weeeks, up from an average of 14.3 weeks in June 1981. Half the unemployed in June were jobless for 11.8 weeks or longer, compared to an average of 6.7 weeks two years earlier.

While the President declares that the economy is "beginning to sparkle," the Administration's own forecasts for 1983-84 project a 9.6% unemployment rate for the last quarter of 1983 and an 8.6% rate for fourth quarter 1984. Full employment, newly defined at 6% in an exercise of statistical obfuscation, is not projected until the end of 1988, and even that forecast is considered too optimistic by some observers (see The Morgan Guarantee Survey, July 1983).

In the midst of current high joblessness and projections of continued unemployment problems we find that exhaustees of regular state benefits are currently eligible for extended benefits in only five states (Alaska, Louisiana, Pennsylvania, West Virginia, and Wyoming), with three of these states slated to terminate extended benefit payments as of August 6. Twelve other states with unemployment rates in excess of 10% (May, latest available) have already triggered off the program (see appended table). This is for a program set up to provide additional weeks of benefits during periods of high unemployment. In Michigan, the total unemployment rate stood at 14.7% in May; yet 56,000 unemployed workers were dropped from the extended benefit program in mid-June when it triggered off. In Indiana, the EB program triggered off at the end of April and the insured unemployment rate has since dropped to 3.6%. Yet, the total unemployment rate reached 10.2% in May. Unemployed workers in three states (Arizona, New Mexico, Tennessee) with current unemployment rates in excess of 10% have been denied extended benefits since the last quarter of 1982. In Tennessee, for example, the total unemployment rate stood at 11.3% in May, yet the insured rate is now less than 3.6% and extended benefits have been triggered off since the last week of September.

The cutbacks in the Extended Benefit Program have led to severe economic hardship for several million workers who have exhausted regular state benefits and/or federal supplemental benefits, and have been denied extended benefits. As a result, the nation's record for cushioning the impact of joblessness has been far worse during this recession than in any other postwar downturn. Even with the additional benefit weeks under the Federal Supplemental Compensation legislation, no more than 40% of the nation's unemployed currently are receiving any unemployment benefits; during the 1974-75 recession, by contrast, nearly three-fourths of the unemployed were receiving benefits.

The more adequate protection afforded unemployed workers in prior years was the product of more reasonable standards for the payment of extended benefits and the enactment of programs to protect exhaustees of extended benefits as well. During the two recessions of the 1970s, for example, legislation was enacted to extend unemployment benefits for durations of as long as 65 weeks. Between January 1972 and March 1973, benefits were extended for an additional 13 weeks, up to a maximum of 52 weeks. Benefits became payable for an additional 13 weeks to exhaustees of extended benefits between January and March 1975, for 26 additional weeks (up to 65 weeks) between March 1975 and March 1977, and for 13 additional weeks (up to 52 weeks) until January 1978. The 13 additional weeks of potential benefits payable between April 1977 and January 1978 were financed by general revenues.

The cutbacks instituted under the Omnibus Budget Reconciliation Act violated the purpose of the federal-state unemployment insurance system, which was established in the mid-1930's in recognition of the enormous costs borne by unemployed workers as a result of economic, political, and social forces over which they have no control. Two major goals were set: first, to cushion workers against economic hardship when they become unemployed through no fault of their own; and second, to bolster purchasing power when total spending is declining, thereby helping to automatically stabilize an historically cyclical economy. The two goals are closely related — an adequate level and duration of benefits are required to ease private adversity and bolster a community's total purchasing power during periods of economic decline and high unemployment.

The legislated changes have seriously weakened the program and its role as a first line of defense against the hardships brought about by rising unemployment. Not only have unemployed workers and their families suffered by the shredding of the already threadbare safety net provided by the unemployment insurance program, but businesses have suffered as well due to the rapid shrinkage of purchasing power in their communities. The number of unemployed workers exhausting their regular state benefits exceeded 400,000 per month in the first five months of this year, and only a small percentage of these exhaustees live in states paying extended benefits.

The costs arising from unemployment and the exhaustion of benefits are being borne privately in the homes of the unemployed; these costs range from financial insolvency, mortgage foreclosures, and the inability to pay for urgently needed medical care to the rise in intra-family tensions and mental health problems. The costs also are being borne socially as the long-term impacts of higher crime, community instability, and mental health problems associated with increasing unemployment begin to spread.

The erosion of the unemployment insurance system has served to undermine its role as an automatic economic stabilizer and thereby has contributed both to the depth and duration of recession and to the accompanying rash of business bankruptcies, especially of smaller businesses that are directly dependent on consumer spending. Business failures in 1982 reached the highest level since 1932, and remain at extremely high levels. The sharp cutbacks in unemployment benefits, along with cutbacks in public assistance and employment programs, have exacerbated the impact of deteriorating economic conditions by weakening the automatic stabilizing role of the program.

In summary, it is essential for the Congress to rescind the changes imposed in 1981. Moreover, the Federal Supplemental Benefit program must not be allowed to expire at the end of the current fiscal year. Legislation to fully restore the Extended Benefit program and to preserve the potential duration available under the FSB program would parallel similar programs enacted in prior recessions.

The UAW advocates a permanent program to provide a maximum benefit duration of 52 weeks under normal circumstances and no less than 65 weeks when the unemployment rate at the national level exceeds the 4 percent goal set forth in the Full Employment and Balanced Growth Act of 1978.

The UAW appreciates this opportunity to share with this Subcommittee our views and our suggestions for reinvigorating a network of programs we believe vital for protecting workers and their communities against the debilitating effects of long-term unemployment.

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Appendix: Unemployment Benefits in High Unemployment States

	Total Unemployment Rate (May 1983)	Insured Unemployment Rate (July 9, 1983)	Status of Extended Benefits-Ending Date	Weeks of Federal Compensation Benefits (July 9, 1983)
Alabama	12.9	4.38	6/4/83	10
Alaska	10.7	6.10	On *	14
Arizona	10.1	3.23	10/23/82	8
California	9.9	4.75	7/2/83	10
Idaho	11.8	4.96	7/2/83	10
Illinois	11.8	5.09	6/25/83	8
Indiana	10.2	3.62	4/30/83	8
Louisiana	12.5	5.61	On	12
Michigan	14.7	4.43	6/11/83	10
Mississippi	11.9	5.22	7/16/83	12
New Mexico	10.3	4.17	11/27/82	10
Ohio	12.9	4.15	5/14/83	10
Oregon	10.2	5.39	7/2/83	12
Pennsylvania	12.1	6.06	On *	14
South Carolina	10.1	3.44	3/19/83	8
Tennessee	11.3	3.58	9/25/82	8
Washington	11.1	5.42	7/2/83	12
West Virginia	18.2	7.84	On	14
Wisconsin	10.2	4.25	6/18/83	10
Wyoming	10.1	5.58	On *	12

* Will end August 6, 1983.

Note: National Civilian Unemployment Rate
— seasonally adjusted: May, 10.1%; June, 10.0%.
— not seasonally adjusted: May, 9.8%; June, 10.2%.

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August 4, 1983

Mr. Roderick A. DeArment,
Chief Counsel
Committee on Finance
Room 219 - Dirksen Senate Office Building
Washington, D.C. 20510

S. 1113 -- 98th Congress, 1st Session,
to provide that tax-exempt interest
shall not be taken into account in
determining the amount of Social Security
benefits to be subjected to income tax.
Senate Finance Subcommittee on Social
Security and Income Maintenance Programs.

Dear Mr. DeArment:

The CCH July 20, 1983 *Taxes on Parade*, Number 34, reports that one may submit five (5) copies of typewritten statements in support of S. 1113. I submit these five (5) copies of my typewritten statement and request that I be supplied with a copy of the proceedings of the above named Senate Finance Subcommittee.

S. 1113 should be passed because H.R. 1900 -- *Social Security Amendments of 1983* -- adding Section 86 to the *Internal Revenue Code of 1954* was a revenue raising measure which did not originate in the House of Representatives. This was in violation of the *United States Constitution*, Article I, Section 7, Clause 1: "All Bills for raising Revenue shall originate in the House of Representatives; but the Senate may propose or concur with Amendments as on other Bills."

S. 1113 should be passed by the Congress because the United States Supreme Court has held that a comparable income tax provision, including tax-exempt income as the basis for the corporate income tax, was held to be unconstitutional as destroying the guaranteed state supremacy guaranteed exemption. (Act of November 23, 1921 (42 Stat. 261, Section 245, in part) -- "Provision of Revenue Act of 1921 abating the deduction (4 percent of mean reserves) allowed from taxable income of life insurance companies in general by the amount of interest on their tax-exempts, and so according no relative advantage to the owners of the tax-exempt securities, held to destroy a guaranteed exemption." National Life Ins. v. United States, 277 U.S. 508 (1928); 1 USTC ¶314; 48 S.Ct. 591.)

Also, the United States Supreme Court has set for oral argument, in due course, the Motion of South Carolina v. Secretary of the Treasury Regan, in No. 94 original jurisdiction for leave to file a Bill of Complaint. (51 U. S. Law Week 3879 at 3882, State of South Carolina v. Donald T. Regan, Secretary of the Treasury of the USA, supported by amici curiae briefs from 23 States, including Texas and Wyoming) South Carolina, in its brief submitted in support of its Motion, states that the provisions of the Tax Equity and Fiscal Responsibility Act of 1982, Section 310 (b)(1), are unconstitutional because: "The Congress of the United States has no power whatsoever to impose an income tax upon interest paid by South Carolina to its lenders."

It has been said by many of the elderly who have relied upon their previously tax-exempt Social Security benefits and municipal bond tax-exempt interest to combat inflation that the *Social Security Amendments of 1983*, as reflected in the amendment in the new *Internal Revenue Code*, Section 86, reflects an inequitable double breach of faith by the Congress. The Internal Revenue Service always proclaims that there is no equity in the *Internal Revenue Code*. S. 1113 should be passed because the Old Age and Survivor Social Security beneficiaries and Railroad Retirement beneficiaries should not be subjected to the unconstitutional provisions of the new *Internal Revenue Code*, Section 86, and have the only possible redress, as aggrieved persons, to bear the great expense of litigating with the Internal Revenue Service in 1985, 1986, or 1987.

I note that on April 25th, 1983 the Committee on Finance requested executive comment from OMB, Treasury Department, Health and Human Services Department. Under the *Freedom of Information Act*, 5 *U.S.C.A.*, Section 552, I request that on receipt of each of these executive comments that you would supply copies of each to me.

For the opportunity afforded to me by the Committee on Finance to make this statement, I express my thanks and I pray that S. 1113 receives favorable action by the Committee on Finance, as well as the Subcommittees, by the Senate and the House of Representatives.

I am sending a copy of this typewritten statement to Senator Alfonse D'Amato, a sponsor of S. 1113. He may wish to duplicate copies thereof and forward them to the other twelve (12) co-sponsors. I am also sending a copy to our Senator from Colorado, William L. Armstrong.

Respectfully yours,

T. Raber Taylor

TRT/rm

cc: Senator Alfonse D'Amato
U. S. Senate
Washington, D.C. 20510

Senator William L. Armstrong
528 Hart Office Building
U. S. Senate
Washington, D.C. 20510

TESTIMONY OF
THE HONORABLE CHRISTOPHER S. BOND
GOVERNOR OF MISSOURI

Mr. Chairman and distinguished Senators, I appreciate the opportunity to submit written testimony on behalf of the National Governors' Association (NGA) and its Committee on Community and Economic Development. The NGA would have liked to have had a witness before you today, but this hearing came in the middle of our annual meeting being held in Portland, Maine.

The National Governors' Association supports S. 1113, a bill to repeal the provision of the Social Security Amendments of 1983 that requires the inclusion of tax exempt interest earned on State and local government obligations in determining whether certain social security benefits will be subject to federal income taxation.

The inclusion of tax-exempt interest in a formula to determine the income payable on a particular recipient's social seciurity benefits encroaches upon the constitutional doctrine of "reciprocal immunity." This doctrine holds that the States are immune from federal interference in their affairs, just as the federal government is immune from state interference. This time-honored doctrine was first applied to interest on municipal bonds by the United States Supreme Court in 1895 in Pollock v. Farmer's Loan and Trust Company wherein the Court held that interest on state and local securities was not subject to federal taxation. One justice wrote: "These bonds and securities are as important to the performance of the duties of the states as like bonds and securities of the United States are important to the performance of its duties, and are exempt from the taxation of the United States as the former are exempt from the taxation of the states."

The right of state and local governments to be free from federal interference when conducting essential governmental or sovereign functions was upheld by the Supreme Court most recently in 1976 in National League of Cities v. Usery. The exercise of borrowing power by States and local governments is a sovereign function which is essential to the separate existence of the States and interference therewith, either directly or indirectly, is beyond the reach of Congressional power.

The fact that the provision in question taxes not the interest on state and local bonds, but only utilizes the income in determining whether to tax the social security benefits makes the provision no less defective. The Supreme Court in the case of American Bank and Trust Co. v. Dallas County, just decided on July 5, 1983, looked at a similar situation where Texas imposed a property tax on bank shares. The tax was computed on the basis of each bank's net assets without any deduction for the value of United States obligations held by the bank. The Court held it made no difference that the tax was not directly on federal obligations. It said that regardless of form, if federal obligations were considered either directly or indirectly in the computation of the state tax, the state tax was barred by federal law. In American Bank and Trust Co., the Court was interpreting statutory law. How more rigorous would the test be under an interpretation of the Constitutional doctrine of "reciprocal immunity," particularly after the American Bank and Trust Co. decision.

Relevant NGA policy in this area (A.-7 entitled State and Local Bonds) reads in part:

> The municipal bond market is a vital source of funds for financing the capital expenditure requirements of state and local governments. To meet the continuing demand for capital, it is imperative that this market provide a dependable source of funds at reasonable interest rates. For

this reason, we oppose proposals to limit directly or indirectly the continued tax exemption of state and local general obligation bonds.

The National Governors' Association supported the recommendations of the National Commission on Social Security Reform. The provision in question was not a Commission recommendation and was not contained in the U.S. House of Representatives version of the bill. In fact, it survived on the Senate floor by a vote of only 52 to 44. The NGA consistently opposed the provision because it was in violation of the Constitution, would impair the municipal bond market, and would result in increased state borrowing costs, with incidentally little revenue gain to the Social Security System.

State and local governments made major contributions to the reform of the Social Security System. States will step up the frequency of their payments of Social Security taxes, and more importantly, States and localities purportedly will be prohibited from withdrawing their employees from coverage under the System in the future. The speed-up of payments alone is estimated to costs States and localities $150 million.

We think it is significant that the Joint Committee on Taxation estimated federal Social Security savings as a result of this provision is only $5 million over a seven year period, while the Municipal Finance Officers Association (MFOA) Government Finance Research Center estimates that future interest costs to state and local government as a result of this provision are expected to increase between $299 million and $599 million each year. Perhaps as significant as the dollar estimates of MFOA is the inability of bond counsel to say that state and municipal bonds are no longer free from either direct or indirect federal income taxation and the perceptions of individual investors that they can no longer be secure that the interest from municipal bonds will be free from federal income taxation in the future. We have been advised that the National Association of Bond Lawyers, an association of approximately 1300 attorneys who regularly practice in the area of public finance, is currently considering whether to recommend to its membership that an express exception should be taken in bond counsel opinions passing on the tax exemption of municipal securities in response to the 1983 Social Security Amendments.

The Social Security Amendments provision in our opinion is a major precedent for the inclusion of tax-exempt interest from state and local obligations in federal taxable income, which can only increase our borrowing costs. States and localities are already undergoing financial stress. Moreover, the cost of our borrowing will increase dramatically as a result of our being crowded out of the financial market by the massive borrowing of the federal government. In addition, other recent actions by Congress have jeopardized or increased the costs of our municipal borrowings. Those actions include:

1) municipal bond registration,
2) a reduction in the personal income tax marginal rates,
3) a reduction in the capital gains rate,
4) the expansion of competing income-sheltering opportunities, and
5) the partial removal of the deductibility of bank interest costs used to finance the purchase of tax-exempt securities.

In summary, the National Governors' Association thinks it is imperative Congress enact S. 1113 so that the Constitution will be upheld and that at least one federal step will be taken to assist states and localities in borrowing at reasonable rates of interest.

Mr. Chairman, NGA would be glad to entertain any questions the Subcommittee may have.